United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

ORIGINAL

To be argued by
ARTHUR L. LIMAN
WILLIAM H. MORRIS

76-6189

United States Court of Appeals

FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant,

—*against*—

BAUSCH & LOMB INCORPORATED and
DANIEL G. SCHUMAN,
Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York

APPELLEES' BRIEF

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Preliminary Statement

This is a meritless appeal in a case which should never have been brought. It has been clear from the beginning that there was no basis for the relief sought by the Securities and Exchange Commission—a permanent injunction restraining Bausch & Lomb Inc. and its chairman, Daniel G. Schuman, from violating the securities laws.

Stripped to essentials, the Commission's case charges that Mr. Schuman improperly disclosed material inside information concerning Bausch & Lomb during an extraordinary two day period in March 1972. The Commission zealously pursued below—as it does here—a judicial declaration that the alleged disclosures in fact constituted violations of Rule 10b-5.

The trial court correctly recognized, however, that the question whether Mr. Schuman violated the securities laws

in 1972 was not the issue in this case. (*SEC* v. *Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1244 (S.D.N.Y. 1976); JA 173-74)* In the Pretrial Order, the Court declared that the issue was: "Is there a reasonable likelihood of future violations which require the issuance of an injunction?" (JA 110) That issue is mandated by the statute under which the Commission brought this action** and by uniform holdings of this Court.

Judge Ward, after seeing the witnesses and carefully analyzing the evidence, denied an injunction and found that: "The SEC simply has not convinced this Court that absent an injunction the defendants will violate the securities laws in the future." (420 F. Supp. at 1244; JA 174) The issue presented on this appeal is whether or not that finding was clearly erroneous and an abuse of the discretion entrusted to the trial court. If it is not, the decision must be affirmed.

In the Commission's statement of the questions presented by this appeal, however, no mention is made of the issue that was tried below or the Court's ultimate finding that there was no likelihood that the defendants would violate the securities laws in the future. (SEC br. 3)

The Commission has run from the issues and hidden from the facts. Rather than confront the real issue on this appeal, the Commission engages in diversionary tactics. It feints first one way and then the other in the hope that the Court will mistake one of the feints for the central thrust of this case.

First, the Commission insists, as it did below, that it is entitled to an advisory determination of whether or not

* "JA" refers to pages of the joint appendix.

** Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d).

the defendants violated Rule 10b-5 in the past. The trial court in response to the Commission's insistence gave careful consideration to the Commission's contention that the defendants had violated Rule 10b-5 in March of 1972 and specifically concluded that: "this Court finds that defendants BOL and Schuman did not violate § 10(b) and Rule 10b-5." (420 F. Supp. at 1244; JA 173) That finding was based, in part, upon the Supreme Court's decision in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), that, at least in private damage actions, proof that defendants acted with *scienter* is a necessary element to establishing a violation of Section 10(b) or Rule 10b-5. After carefully analyzing the reasoning of the Supreme Court, Judge Ward stated his belief "that the *Hochfelder* holding must be read to impose a *scienter* requirement in this suit for injunctive relief brought by the SEC." (420 F. Supp. at 1240; JA 168) It was this statement that led the Commission to appeal. (SEC br. 2)

We believe that Judge Ward's statement on *scienter* was correct and clearly compelled by the Supreme Court's reasoning in *Ernst & Ernst* v. *Hochfelder.* Nevertheless, that statement, in the context of this appeal, is equally clearly *dictum.* The trial court specifically held that, even had a violation been established, the record did not warrant an injunction because the Commission had failed to establish any likelihood of future violations. (420 F. Supp. at 1244; JA 174) The Commission does not, even now, suggest otherwise. Not once in its brief does the Commission suggest that there is any reasonable likelihood that Bausch & Lomb or Mr. Schuman will violate the securities laws in the future in the absence of an injunction.

We recognize that the Commission is uncomfortable with *Ernst & Ernst.* But this is not the case for determination of the *Ernst & Ernst* question. The trial court's refusal

to issue an injunction was based on its unchallenged finding that the defendants were not likely to violate the law. This rested not on an interpretation of *Ernst & Ernst*, but rather an adherence to standards promulgated by this Circuit both before and after *Ernst & Ernst*. Thus, the denial of the injunction was not an abuse of discretion irrespective of the outcome of the *scienter* debate. The Commission's discomfort does not warrant this Court in issuing an advisory opinion on the *scienter* issue.

The second of the Commission's diversions is a half-hearted attempt to have this Court retry the case. The Commission does not squarely challenge any of Judge Ward's findings of fact, apparently recognizing that they are beyond reasonable dispute. Indeed, its statement of facts does not even refer to the findings below. (*See* SEC br. 4-18) But—taking great liberties with the record—the Commission endeavors to create the impression, through the twin devices of imaginative characterization and dogged repetition, that Mr. Schuman was a reckless and frequent "leaker" of inside information.

The Commission's effort to create a new record on appeal should fail. The picture which the Commission would paint is wildly distorted. More important, however, is the fact that the Commission has had its day in the trial courtroom, and it may not now ignore the bulk of the trial record, which supports the findings below, and advance theories never urged upon the trial court. This Court, in short, should not try this case *de novo*.

At root, this appeal is simplicity itself, not the landmark case which the Commission would make of it. The trial court, after seeing and hearing the central figure in these events, saw no need for an injunction. There is no proper basis for upsetting that considered judgment, and there is no need for this Court to dwell at length on the

legal theories pressed by the Commission. The *scienter* issue is immaterial to disposition of this case, and this Court should not succumb to the Commission's plea for an advisory opinion.

Question Presented

Did the trial court abuse its discretion in declining to issue an injunction against Bausch & Lomb and Mr. Schuman?

Statement of the Case*

Virtually all of the Plaintiff's Contentions, as set out in the Pretrial Order (JA 96-103), deal with conversations between Mr. Schuman and various securities analysts on March 15 and 16, 1972.** The record below demonstrates that in those conversations Mr. Schuman acted in good faith compliance with the policies of the SEC and the New York Stock Exchange relating to contacts between public companies and securities analysts. Before reviewing the nature of those specific conversations, it is necessary to consider, as the trial court did, the context in which those interviews were conducted in 1972. This requires an analysis of the policies of the Commission and the New York Stock Exchange as well as an understanding of the specific factual matters relating to Bausch & Lomb and its stock in the spring of 1972.

* A full statement of the facts unfortunately is made necessary by the fact that the recitation in appellant's brief, although artful, bears little relationship to the case actually tried before Judge Ward.

** The single exception dealt with the contention that a press release issued on March 1, 1972, was misleading. That contention was essentially abandoned at trial and is not raised on this appeal.

Background

This case arises out of contacts on March 15-16, 1972 between Mr. Schuman and three securities analysts who followed Bausch & Lomb. One's first reaction to the case might well be to ask why Mr. Schuman was talking to securities analysts to begin with, and perhaps also to suspect that it was inherently wrong to do so. It is plain, however, that Mr. Schuman was properly discharging his duties in meeting with analysts. Indeed, putting aside one "uncharacteristic and inadverent" slip (420 F. Supp. at 1242; JA 171), he was particularly circumspect in avoiding any disclosure of material inside information to analysts in the course of such contacts.

Analyst—Management Meetings— The "Open Door" Policy

The trial court found that both the Commission and the New York Stock Exchange consistently have encouraged public companies to observe an "open door" policy towards securities analysts, and others who have a legitimate interest in company affairs, and to respond to their factual inquiries. (420 F. Supp. at 1230; JA 148) Hence, meetings with analysts are not only proper—they further significant Commission and Stock Exchange policies.

On August 16, 1971, the Commission issued Securities Act Release No. 5180, which provided in pertinent part (Ex 220*):

> "[T]he Commission as a matter of policy encourages the flow of factual information to shareholders and the investing public. Issuers in this regard should: . . . 5. Answer unsolicited telephone inquiries from stockholders, financial analysts, the press and others

* "Ex" refers to pages of the exhibit volumes.

concerning factual information. 6. Observe an 'open door' policy in responding to unsolicited inquiries concerning factual matters from securities analysts, financial analysts, securities holders, and participants in the communications field who have a legitimate interest in the corporation's affairs."*

The Commission repeatedly has acknowledged the potential benefits to investors from meetings between analysts and corporate officials. In *Matter of Investors Management Co.,* Securities and Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] FED. SEC. L. REP. ¶ 78,163, at 80,521, quoted at length by the trial court (420 F. Supp. at 1230-31; JA 148), it stated:

> "We appreciate the concerns that have been expressed about the need to facilitate the free flow of information throughout the financial community. We have consistently required or encouraged the broadest possible disclosure of corporate information so as to provide public investors and their professional financial advisors with the most accurate and complete factual basis upon which to make investment decisions. We also recognize that discussions between corporate management and groups of analysts which provide a forum for filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value."

Even after the decision below, the Commission reaffirmed its commitment to the "open door" policy, noting:

> "In our view [meetings with securities analysts, brokers and other members of the professional investment community] are generally desirable because

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* Copies of Release No. 5180 were in Bausch & Lomb's files in March 1972. (JA 81 ¶ 5)

> they have the eventual effect of conveying useful information to the investing public, and we do not believe they should be discouraged. SEC Staff Reply, [Current] FED. SEC. L. REP. ¶ 81,118 (Feb. 3, 1977).

Similarly, since 1968 the New York Stock Exchange Company Manual has stated (Ex 222, 224):

> "Security analysts play an increasingly important role in the evaluation and interpretation of the financial affairs of listed companies. Annual reports, quarterly reports, and interim releases cannot by their nature provide all of the financial and statistical data that should be available to the investing public. The Exchange recommends that corporations observe an 'open door' policy in their relations with security analysts, financial writers, shareowners, and others who have a legitimate investment interest in the company's affairs."

Although the Commission has encouraged interviews with analysts and recognized the need for guidance in this area, it has not furnished clear guidelines as to the permissible subjects for discussion to stand as guideposts for corporate management attempting in good faith to conform their conduct to the often hazy requirements of Rule 10b-5. (*See* 420 F. Supp. at 1231, 1245 and n.5; JA 149, 175, 189-190) The Commission has suggested at various times that such guidelines would be forthcoming, but apparently has been unable to produce them. *See* G. Bradford Cook, *The Role of the Analyst in the Evolving Market System* (DX M at p. 10); Ray Garrett, Jr., *A Commission's Dilemma: Directors' Guidelines Revisited* (DX U at p. 1).

To the extent that authoritative guidance was available in 1972, it was plain that company managements were not limited to parroting the substance of press releases in speaking to analysts. The trial court found that the available guidance (420 F. Supp. at 1231; JA 149-50):

> "suggested that corporate officials should conduct themselves reasonably and that this standard would permit general discussion out of which a skilled analyst could extract pieces of a jigsaw puzzle which would not be significant to the ordinary investor but which the analyst could add to his own fund of knowledge and use towards constructing his ultimate judgment. Discussions with analysts regarding earnings prospects, trends in products, operating conditions, and the implications on earnings of a particular volume of business were approved. Responses to 'ball park' estimates were deemed proper. This, of course, assumed management was, 'not trying to give their stock a little jiggle,' and did not 'go overboard.'" (*See* 420 F. Supp. at 1231 and n. 1; JA 177-183)

In support of this description, the trial court pointed in particular to a widely reported 1972 speech to the Financial Analysts Federation by Philip A. Loomis, then General Counsel and later a Commissioner of the SEC (hereinafter the "Loomis speech"). (420 F. Supp. at 1231 n. 1; JA 180; *see also* Ex 228-307)

Mr. Schuman and Analysts

The other salient fact relevant to a full appreciation of the events of March 15-16, 1972 is the well known reticence of Mr. Schuman and Bausch & Lomb in dealing with analysts.

As Bausch & Lomb's executive vice president, Mr. Schuman was solely responsible for the company's contacts with the financial community from 1967 until May 1971, when he became chairman of the board. (JA 80-81, 295) Upon assuming the chairmanship, he continued those duties until

a vice president for finance could be hired and be able to take over those duties, which did not occur until late March 1972. (JA 81, 295)

During that period, Mr. Schuman's policy was not to initiate contacts with analysts, but to respond to their inquiries pursuant to Bausch & Lomb's obligation under the open door policy. (JA 297) He was sensitive to his responsibilities with respect to inside information and made it a practice not to release material data to analysts. (JA 295-96, 298-99) It had never even been suggested that he had released material inside information in any of the hundreds of analyst contacts he had over the years. (JA 298) Quite the contrary.

The evidence showed, and the trial court found, that the release of material information by Mr. Schuman—the earnings estimate in the March 16, 1972 telephone call—was "uncharacteristic and inadvertent." (420 F. Supp. at 1242; JA 171) Mr. Schuman and Bausch & Lomb had a standing rule against commenting upon analysts "numbers". (JA 263, 265) Mr. Schuman testified that he would not discuss earnings estimates with analysts. (JA 298) This testimony was confirmed by each of the analysts called by the Commission at trial. Mr. Burkhead of Smith, Barney testified that during the course of his contacts with Bausch & Lomb, no one at the company had ever given him an earnings estimate or an estimate of Soflens earnings or sales. (JA 683) Sheldon Greenburg of IDS testified that, while other companies he was following discussed earnings estimates with him (JA 634), Mr. Schuman and Bausch & Lomb had never given him an earnings estimate or an estimate of Solflens sales or earnings. (JA 632-633) Nor had he heard about Mr. Schuman's ever giving anyone else an estimate. (JA 640) David MacCallum testified that Mr. Schuman would not talk about earnings. (JA 621) The trial court,

in its findings, pointed to analysts' publications which reported that "the company is difficult to communicate with" and that "[t]he company as consistent with its past practice is not providing information to make an informed estimate on shipments . . ." (420 F. Supp. at 1242; JA 170-71, Ex 39, 44) And it relied on testimony by one analyst that "Mr. Schuman was a relatively difficult man to speak with," and that his "answers to me were relatively vague, vaguer than the normal flow of answers from companies with which I speak. He certainly never offered information. He certainly did not expand." (420 F. Supp. at 1242; JA 171) And yet this is the man who the Commission—on appeal from a contrary finding below—would smear with the label "tipper."

* * *

It is against this background that Mr. Schuman's March 15-16, 1972 contacts with analysts must be evaluated—a background of official encouragement for such contacts and scrupulous and successful efforts by Mr. Schuman to avoid even an inadvertent release of material inside information.

Events Leading to March 15-16, 1972

During 1971 and early 1972, Bausch & Lomb aroused ever-increasing interest in the financial community, largely as a result of its introduction of an exciting new soft contact lens sold under the trade name "Soflens" contact lens (hereinafter "Soflens").

Bausch & Lomb introduced Soflens through a series of introductory symposia held across the country during the second half of 1971. At those symposia, the lenses were sold to practitioners (ophthalmologists, optometrists and opticians) in kits each holding 72 lenses. The practitioners thereafter purchased more lenses in whatever quantity they chose. (420 F. Supp. at 1228-29; JA 143, 83 ¶ 9) This

introductory sale of the inventory kits often was referred to as the "filling of the pipeline."

A substantial number of inventory kits were sold in 1971 and this had a significant positive impact on Bausch & Lomb's sales and earnings for the second half of that year. (420 F. Supp. at 1229; JA 143, 83 ¶ 10) Beginning late in 1971, however, and intensifying throughout the first quarter of 1972, a wave of negative publicity—"flak"—developed about soft contact lenses. (420 F. Supp. at 1229; JA 145) Articles in the press suggested that soft contact lenses were subject to bacterial contamination and thus posed a health threat to their users. (420 F. Supp. at 1229; JA 145; Ex 363, 368, 374, 388-89). At the same time, reports of the possibility of competition from other manufacturers of soft lenses were circulating. (420 F. Supp. at 1229; JA 145; Ex 375-76, 378-79, 414) In addition, reports of FDA investigations of soft contact lenses appeared in the press. (420 F. Supp. at 1229; JA 145; Ex 376)

While reports of problems with soft lenses proved to be false, at least as applied to Bausch & Lomb's Soflens (JA 312-17), they had a substantial impact on the price of Bausch & Lomb stock traded on the New York Stock Exchange ("NYSE"). On February 23, for example, the morning of the first publication by the *Wall Street Journal* of an erroneous rumor that du Pont would enter the soft contact lens business (Ex 376-77), Bausch & Lomb dropped 14⅞ to $171 on a delayed opening and closed down 11⅜ points for the day. (Ex 378) Between January 28, 1972, and March 10, 1972, the price of Bausch & Lomb on the Exchange slid from $194.75 to $145. (420 F. Supp. at 1229; JA 145; Ex 417-20)

The trial court found that the negative publicity and the conclusion of the introductory symposia caused both analysts and the company to anticipate a drop in practitioner and consumer demand for Soflens and, therefore, a drop

in Soflens sales, in the first quarter of 1972. (420 F. Supp. at 1229-30, 1236-37; JA 145-46, 154-57, 316-17) With the symposia completed, further sales would be limited to replacements of lenses sold out of the original large kits and new orders from practitioners who were not sufficiently interested to respond to the initial promotional campaign. Consumer acceptance was at best a matter of speculation; the adverse press reports were expected to have a negative impact. Indeed, on January 19, 1972, Mr. Schuman was quoted in the *Wall Street Journal* as saying: "We are disturbed as to the confusion and doubt this [adverse publicity about other soft contact lenses] creates in the minds of practitioners and the public. . . ." (Ex 37; JA 317) The anticipated drop in Soflens sales as a result of these factors was widely reported to the investment community, in the financial press, and in published analyst reports. (*See* Ex 37, 43-50, 53-54, 58-60, 344-58, 363)

As February ended and March began, the flak regarding Bausch & Lomb began to reach a crescendo.

On February 29, 1972, Smith, Barney & Co.—which theretofore had strongly recommended purchase of Bausch & Lomb stock—withdrew its "buy" recommendation on Bausch & Lomb. (Ex 358; *See* 380-83, 388-89) According to its report, Smith, Barney changed its recommendation because of uncertainties arising from: (1) recurrent negative publicity which questioned both the safety and efficacy of soft contact lenses; (2) periodic concern that the FDA might impose restrictive regulatory controls; and (3) the possibility of competition in the soft contact lens area. Although the report stated that these concerns were not supported by objective evidence, it nevertheless concluded that the cumulative impact of these factors could significantly restrain investor psychology regarding Bausch & Lomb. The report stated also that domestic Soflens sales appeared to have slowed in recent weeks, indicating a

slower rate of acceptance than implied in earlier Smith, Barney forecasts. (Ex 358; 420 F. Supp. at 1229-30; JA 145-46)

The impact of the Smith, Barney release illustrates the significance of the flak to the financial community. It was issued after the close of the New York Stock Exchange on February 29, but before the close of the Pacific Stock Exchange. At 5:20 P.M., Eastern Standard Time, minutes after the distribution of the report by wire, Bausch & Lomb dropped from $167.50 to $158 on the Pacific Stock Exchange. (JA 89 ¶ 37)

The bad news continued on the following morning. On March 1, 1972, in response to a rumor concerning a temporary interruption in Soflens shipments, Bausch & Lomb issued a press release reporting that shipments of Soflens had been suspended temporarily. The suspension was the result of an apparent leakage problem in the shipping vials containing the lenses and was designed to permit Bausch & Lomb to change the method of sealing the vials and to test them for sterility.* The release reported also that

* In a shallow and disingenuous attempt to portray a "pattern" of selective disclosures, the Commission now implies that Bausch & Lomb issued the press release only at the instance of the New York Stock Exchange and claims that Don Allen, a Bausch & Lomb officer, acted improperly in confirming the rumor to the analyst who informed him of it at 5 P.M. on the 29th. (SEC br. 7-8, Ex 137) Both of these new assertions are seriously misleading.

First, the uncontradicted proof is that Bausch & Lomb decided to issue the March 1 press release before it first communicated with the New York Stock Exchange. It called the Exchange only to "get any comments" the Exchange "might have with respect to the press release and . . . also to give [it] advance warning of the fact that the press release would be forthcoming." (Ex 137-45; JA 209)

Second, the claim of impropriety in Mr. Allen's confirmation of the rumor that Bausch & Lomb had stopped shipping Soflens is absurd.

(footnote continued on following page)

shipments were scheduled to resume the next day, March 2, 1972. (420 F. Supp. at 1230; Ex 27; JA 146)

When the release was issued, shipments were scheduled to resume on March 2. However, shipments ultimately were not resumed until eight days later, on March 10, solely because Bausch & Lomb was awaiting the receipt of certain test results which were received on a day-to-day basis through March 9. (420 F. Supp. at 1230; JA 146, 86 ¶ 19) Shipments were caught up prior to the end of the first quarter of 1972. (*Ibid.*) Thus, the temporary shipping delay itself was of no significance. Indeed, the only significance of the release was that the press treatment of the shipping vial problem discussed in it added to the flak which had been creating doubt about Soflens. (Ex 388; JA 226-28)

Mr. Schuman was away from his Rochester office from February 23, 1972 until Sunday, March 12, 1972, as the bad publicity concerning Soflens mounted.* (JA 86 ¶ 20) While he was away, a number of securities analysts concerned about the impact of developments on Bausch &

Not only does the record show that the brief shipment interruption was not material (*infra*, p. 15), but it is equally plain that Mr. Allen confirmed the rumor after the close of trading on February 29 (Ex 137) and, as the Commission admits, that Bausch & Lomb issued its press release on March 1 before trading opened (SEC br. 8). Moreover, the Commission did not contend before trial that Mr. Allen's conduct was improper (JA 96-102, 67-78) and never seriously advanced this contention below. It should not be heard to do so here. Indeed, the Commission's only contention below with regard to the March 1 release was that the release itself was misleading (JA 96 ¶ 1, 85 ¶ 18)—a claim it now quietly abandons.

It would seem that the Commission raises this claim at this late date solely to justify its blatantly misleading heading "Seventeen Days in March: A Tale of Selective Disclosures and Massive Selling Reaction". (SEC br. 7)

* His only involvement, relevant here, during that period was to approve by telephone the issuance of a press release on March 1.

Lomb requested appointments from Mr. Schuman's secretary to speak with him. Although she did not ordinarily make appointments without his knowledge, she set up several interviews—including those with Lewis A. Sanders of Sanford C. Bernstein & Co., Byron Wien and Richard J. Clancy, partners in the investment firm of Brokaw, Schaenen, Wien, Clancy & Co. ("Brokaw"), and with David A. MacCallum of Faulkner, Dawkins & Sullivan ("FDS"). (420 F. Supp. at 1230; JA 146, 91-92 ¶¶ 48, 51; JA 350-51)

Consistent with his established policy, Mr. Schuman did not initiate these analyst interviews. Indeed, he was reluctant to attend them. However, as the trial court found: "Although he had misgivings about the meetings, Schuman decided to go ahead with them rather than appear to be 'ducking' the analysts and their anticipated discussions of the decline in his company's stock. Additionally, he was interested in learning what the analysts were thinking and hoped that speaking with them would help to prepare him for a planned meeting with Dan Dorfman . . ., Dow Jones staff reporter and Wall Street Journal columnist." (420 F. Supp. at 1230; JA 146-47, 351-52)

The Events of March 15-16

The Commission's brief repeats the phrase "selective disclosure" many times in its discussion of the events of March 15-16, 1972. That phrase, however, aptly characterizes the Commission's statements of the facts not Mr. Schuman's actions.

The Sanders Interview

The most flagrant omission from the Commission's account of these two crucial days is Mr. Schuman's meeting on March 15, 1972, with Lewis A. Sanders, an analyst with the firm of Sanford C. Bernstein & Co. (420 F. Supp. at 1234; JA 151, 94 ¶ 58)

Mr. Schuman covered the same ground with Sanders as he did with the other analysts he saw on March 15 and 16. (420 F. Supp. at 1234; JA 152, 353-55) Mr. Schuman and Sanders discussed the effect the flak was having on Soflens sales. In that context, Mr. Schuman told Sanders—as he told Wien and Clancy later the same day and MacCallum the next morning—that warranty cards returned to Bausch & Lomb by new lens purchasers indicated that the sales trend line was flattening out, but cautioned against drawing any conclusions from that data because it was based on only a couple of weeks and a longer period was necessary before the information could be regarded as significant. (JA 353-54, 362-63, 381-84) They also discussed Bausch & Lomb's plans for introducing aphakic lenses—Soflens contact lenses for cataract patients—and a new smaller kit for practitioners. Mr. Schuman told Sanders—as he was to tell the others—that Bausch & Lomb expected to ship aphakics in late April or May and the minikit at the end of the quarter. (JA 354-55, 248-50, 259, 502)

Since Mr. Schuman told Sanders almost precisely the same things as he did Wien, Clancy and MacCallum, the Commission's treatment of this meeting is striking indeed. But the reason for its silence is clear. After Sanders' meeting with Mr. Schuman—after receiving what the Commission characterizes as material adverse inside information in the context of the Wien and Clancy and MacCallum meetings—Sanders confirmed his existing "buy" recommendation on Bausch & Lomb and his firm bought 850 shares for discretionary accounts. (420 F. Supp. at 1234; JA 151-52) Sanders' action simply is not consistent with the Commission's claim that the subject of the interview was material inside information—so the Commission tries to sweep it under the rug.

The Wien-Clancy Interview

The Commission's description of the Wien-Clancy meeting is another example of its "selective disclosure." From reading the Commission's brief, one might assume that Wien and Clancy walked into Mr. Schuman's office and that Mr. Schuman simply began giving them hard, factual information hitherto unknown in the investment community. Nothing could be farther from the truth.

Wien and Clancy met with Mr. Schuman immediately after the Sanders interview, beginning between 3:30 P.M. and 4:00 P.M. on March 15, 1972.* (420 F. Supp. at 1234; JA 152, 91 ¶ 48) The natural focus of this discussion, as the others, was the adverse publicity concerning Soflens and its impact on Bausch & Lomb. As the trial court found, Wien and Clancy—like the rest of the investment community (420 F. Supp. at 1236; JA 157)—were well aware of the adverse publicity and assumed that Soflens sales were being hurt by it. (420 F. Supp. at 1235; JA 154) The basic facts leading to that conclusion, however, were not internal corporate information, but matters of public knowledge. As early as January 1972, Mr. Schuman had expressed to the *Wall Street Journal* his concern about the effect of the negative publicity. (Ex 37) The likely impact of the flak on Soflens sales had been the subject of numerous reports in the financial community. (JA 318; Ex 37, 43-50, 53-54, 58-60, 344-58, 363)

The interview appears to have taken place because of Wien and Clancy's concern about the impact of the flak. They took the initiative, at the beginning of the meeting, in raising the problem of the adverse effect of the flak on Soflens sales. The trial court found, "in Schuman's

* It should be noted that Mr. Schuman had no prior relationship with Wien and Clancy. He hardly knew who they were. (JA 239)

words, '[t]hey were telling me that everything was going to hell . . . .'" (420 F. Supp. at 1235; JA 154) They argued that Bausch & Lomb had to start a strong public relations program to promote Soflens directly to the consumer—as opposed to Bausch & Lomb's established practice of working through the practitioners—or find itself in still greater difficulty. (420 F. Supp. at 1235; JA 154, 240-42, 360-62)

Mr. Schuman responded to this virtual tirade by acknowledging the problems facing Bausch & Lomb. As he had done with Sanders (JA 353-54), he noted that the warranty cards returned by new purchasers indicated a flattening of sales of Soflens in recent weeks. The Commission, however, fails to note that Mr. Schuman took pains also to point out his belief that the apparent flattening of the sales line was not significant because it reflected short-term problems, might reflect no more than a seasonal pattern that had long been associated with hard contact lenses, and was based on inherently unreliable data, as the return of warranty cards by consumers is rather uncertain. (JA 353-54, 362-63, 381-84) He continued to express long-term confidence in the product, as well as in Bausch & Lomb's promotional techniques. (JA 361-62, 384) Thus, far from leaking material inside information about sales trends, Mr. Schuman simply parried as best he could the attack made by men only too aware of the Soflens sales picture.

The Commission's claims with respect to alleged disclosure of annual earnings estimates (SEC br. 10) also are less than candid. Relying exclusively on a transcript of an *ex parte* investigational hearing, it first asserts that Mr. Schuman told Wien and Clancy that he had urged Sanders —who was using a $5 per share estimate—to be more conservative. (*Ibid.*) But it fails to state that Mr. Schuman denied that charge, under oath and subject to cross-

examination, and that the trial court credited Mr. Schuman's testimony.* The Commission then claims, on the basis of the same *ex parte,* hearsay transcript, that Mr. Schuman said that $3 per share was too low (*ibid.*), but again it fails to note that the live testimony was to the contrary and that the trial court resolved the conflict against the Commission. (JA 363-64, 371-72, 153) More important, it ignores the fact that $3 per share was an absurdly low figure, sarcastically thrown out by Wien and Clancy in an apparent effort to goad Mr. Schuman into acknowledging the seriousness of the problem as perceived by Wien and Clancy. (JA 363-64, 371-72) No one seriously entertained any thought that Bausch & Lomb's earnings might fall so far. (*See* JA 246, 359)

The next instance of "selective disclosure" in the Commission's brief is the claim that Mr. Schuman told Wien and Clancy that the Soflens sales rate was less than one lens per practitioner per week. (SEC br. 10) The trial court saw no need to resolve the question whether the statement was made (JA 254, 372-74; Ex 81-82), for one thing is plain—the information was meaningless. Without knowledge of the number of fitting practitioners—which was not disclosed (JA 374)—the rate of fittings would be of no assistance to anyone.

During the course of the interview, Mr. Schuman told Wien and Clancy—as he had told Sanders (JA 354-55)—

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* Mr. Schuman testified that he said that Sanders was using a $5 per share figure, that he never responded to the Sanders figure, and that there followed a philosophical discussion about analysts' expectations during which he said that analysts generally should be more conservative. (JA 244-47, 357-60) The trial court held: "The evidence concerning the revelation of earnings estimates by Schuman . . . is not convincing, it cannot fairly be said that Schuman made statements which could be characterized as disclosures of earnings." (420 F. Supp. at 1235; JA 153)

that Bausch & Lomb expected to ship the aphakics in April or May and the Soflens minikit at the end of March. (JA 248-50, 364) This was routine operational information which was disclosed by Bausch & Lomb to anyone who asked for it; Bausch & Lomb's marketing division routinely responded to customer inquiries with the same information. (Ex 421-27; *see* 420 F. Supp. at 1235; JA 153) Naturally, the schedule for shipping the aphakics and the minikit, as any addition to a product line, was subject to slight changes and delays. Neither Mr. Schuman, nor Wien and Clancy, attached any significance to these facts. (420 F. Supp. at 1235; JA 154, 364-65; Ex 90-91) Indeed, Clancy indicated shortly after the interview that he did not even remember that the subject of the aphakics had been discussed. (420 F. Supp. at 1235; JA 154; Ex 90-91)

No significant specific information was disclosed by Mr. Schuman during this meeting, and neither Mr. Schuman nor Wien and Clancy believed that the information which they discussed was material. (420 F. Supp. at 1235; JA 154-55; Ex 90-91) Consistent with Mr. Schuman's recognized policy (420 F. Supp. at 1242; JA 170-71, 298-99, 303-04, 567-69, 617-18, 620-21; Ex 39, 44, 339, 359, 365), he did not disclose or even confirm any specific earnings estimate. No specific sales figures were discussed. Rather, the significance of the interview lay in the opportunity it gave Wien and Clancy to form first-hand impressions of Bausch & Lomb management and its ability to deal with the problems facing Soflens—a purpose of analyst meetings encouraged by the Commission. (*See, supra,* p. 7) Accordingly, the Court found "that the remarks made by Schuman during [the Clancy and Wien] interview did not rise to the level of disclosure of material, nonpublic information." (420 F. Supp. at 1235; JA 155) In fact, Clancy and Wien reached differing conclusions on the basis of this interview. (*See infra,* pp. 26-27)

The Warner-Lambert Announcement

While Mr. Schuman was meeting with Wien and Clancy on March 15, an event with important ramifications for Bausch & Lomb was taking place. Beginning at 3:58 P.M., the first of a series of wire service stories concerning a press release by Warner-Lambert was transmitted. Warner-Lambert is the parent company of American Optical Company, the largest firm in the ophthalmic industry. Its March 15 press release reported that discussions with Frigitronics concerning the manufacture and distribution of another soft contact lens being developed by Frigitronics were progressing satisfactorily. (420 F. Supp. at 1239; JA 164, 91 ¶ 50; Ex 395-96) Thus, after the close of the Stock Exchange on March 15, the financial community learned that a well-equipped competitor might be on the verge of entering into competition with Bausch & Lomb's Soflens—which previously had been the only soft contact lens on the market. (JA 82-83 ¶ 8)

The MacCallum Interview

On March 16, 1972, MacCallum met with Mr. Schuman in Mr. Schuman's office in Rochester from approximately 9:00 until 11:00 A.M. (420 F. Supp. at 1235-36; JA 155; JA 92 ¶ 52) It is impossible to understand what transpired at the meeting and, more importantly, thereafter, without knowing something of the history of MacCallum's relationship with Bausch & Lomb stock prior to March 16—a subject on which the trial court made extensive findings which largely are ignored by the Commission.

MacCallum was one of the leading analysts following Bausch & Lomb and Soflens. Beginning in early 1971, he devoted considerable time to independent research and analysis concerning Soflens. He spoke personally with practitioners, to an insurance company insuring Soflens

contact lenses, and to Bausch & Lomb's competitors. He even used himself as a "guinea pig" by having himself fitted with both Soflens contact lenses and a competitive lens that had not even been approved by the FDA. (420 F. Supp. at 1236; JA 155, 560-65)

The trial court found that "the events of 1972 caused MacCallum to reevaluate his position." (420 F. Supp. at 1236; JA 155) MacCallum was well aware of the negative publicity concerning the possibility of contamination, FDA regulations and new competition and of its likely impact on acceptance of Soflens. (420 F. Supp. at 1236; JA 155, 589) In fact, his firm had commissioned a survey of Soflens practitioners which showed that the acceptance level was lower than expected. (420 F. Supp. at 1236; JA 155, 575)

In mid to late February or early March 1972, MacCallum decided to withdraw his "buy" recommendation on Bausch & Lomb and to lower his estimates for the company's first quarter and annual 1972 earnings. (420 F. Supp. at 1236; JA 156, 159, 579-81, 584) His decision was based on his independent conclusion that consumer and practitioner acceptance of the Soflens contact lens was significantly lower than he had anticipated. (420 F. Supp. at 1236; JA 156, 573-75) After reaching that decision, MacCallum met with Dwight Faulkner, managing partner of FDS. Faulkner told MacCallum not to change his recommendation or his estimates without first going to see Bausch & Lomb, as it was an established practice at FDS to visit the subject company prior to withdrawing a buy recommendation or altering an earnings estimate. (420 F. Supp. at 1236; JA 156, 580-84, 601-04; Ex 201-02) MacCallum's change of recommendation was delayed solely because of Mr. Schuman's absence from Rochester, which made it impossible for MacCallum to set up a meeting with him for earlier than mid-March. (420 F. Supp. at 1236; JA 156)

Following MacCallum's meeting with Faulkner, MacCallum published a research report on Bausch & Lomb dated March 2, 1972. The report—solely the product of his own research and analysis—lowered MacCallum's estimates of kit sales for the first quarter of 1972 and for the full year by about 40 percent as compared to his earlier estimates, which were contained in a draft dated February 22. (420 F. Supp. at 1236; JA 156; *Compare* Ex 41 *with* Ex 5; JA 577-78, 599-602) Despite this great reduction in the estimated kit sales, which necessarily required revision of MacCallum's prior earnings estimate, the March 2 report carried the same earnings estimate as the February 22 draft as a result of Faulkner's instructions. (420 F. Supp. at 1236; JA 156, 601-03)

In short, as the trial court properly found, MacCallum had decided well before the meeting with Mr. Schuman to withdraw his buy recommendation and lower his earnings estimates on Bausch & Lomb. (420 F. Supp. at 1236, 1237; JA 156, 159, 585, 612-13) Indeed, it was highly unlikely that Mr. Schuman could have said anything that would have altered MacCallum's decision to change his recommendation and lower his earnings estimate, since MacCallum already had lowered his sales estimates.

Prior to MacCallum's trip to Bausch & Lomb on March 16, FDS clients were advised that MacCallum would be seeing the company. In addition, Derrick C. Hoitsma, manager of the trading department of FDS, arranged for MacCallum to telephone him as soon as MacCallum left the company, because Hoitsma was concerned about the action of Bausch & Lomb stock. (420 F. Supp. at 1236; JA 156, 479-80, 604) The ritual of MacCallum's visit to Bausch & Lomb was merely a device to give FDS an ostensible justification for lagging behind Smith, Barney, another firm prominently following Bausch & Lomb (*see supra*, p. 13), in changing its recommendation and estimates.

During the interview, MacCallum and Mr. Schuman had a wide-ranging discussion touching on many aspects of Bausch & Lomb's business, including both Soflens and the traditional scientific and ophthalmic lines. No significant, specific information was disclosed by Mr. Schuman. They discussed essentially the same subjects as Mr. Schuman discussed with Sanders, Wien and Clancy. (420 F. Supp. at 1236; JA 157)

Thus, MacCallum expressed concern that the adverse publicity concerning soft contact lenses and other matters were having a negative effect on Soflens contact lens sales. (420 F. Supp. at 1236; JA 157, 261-62) In that context, Mr. Schuman told MacCallum, as he had told other analysts, that although the returned warranty cards indicated that the trend line of sales seemed to have flattened out over the past three weeks, this did not have any significance because one could not properly draw conclusions from this data, which was both scanty and unreliable. (JA 381-84) They discussed also that the small Soflens kits would be shipped around the end of March; that the aphakic lenses would be shipped around the end of April or May; and that the company was preparing its quarterly forecast, a routine budgetary practice. (420 F. Supp. at 1236; JA 157, 258-59, 378-79, 502, 570)

At one point, MacCallum told Mr. Schuman his estimates of the number of kits sold and patients fitted in 1971 and expected for the first quarter of 1972 and tried to get Mr. Schuman to comment. Mr. Schuman responded that he would not comment on MacCallum's figures. (JA 263-66) It was MacCallum's impression that the numbers were in the ballpark.* (JA 613)

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* According to SEC General Counsel Loomis, it would have been proper for Mr. Schuman to tell MacCallum that his estimates were "in the ballpark." (420 F. Supp. at 1231-32 and n. 1; JA 180)

Mr. Schuman did not disclose to MacCallum any internal earnings estimate or any figure for Soflens contact lens sales to practitioners or consumers. (JA 380-81, 426, 568-69, 585, 614) Nor was any other significant or new information discussed. (JA 585, 612-14) As the trial court described the meeting:

> "A review of the testimony of both participants gives the impression of a very knowledgeable analyst having undertaken considerable research and having subsequently formulated certain opinions which he sought to verify in his discussion with Schuman. On the other hand, Schuman appears to have attempted to candidly discuss that which was general knowledge among those in the investment community who followed BOL stock, while parrying efforts to lure him into forbidden territory. Evidence that Schuman overstepped the bounds of proper disclosure in his March 16 interview with MacCallum was not conclusive." (420 F. Supp. at 1236; JA 157)

The Analysts' Conclusions

The information discussed by Mr. Schuman in each of his interviews on the afternoon of March 15 and the morning of March 16, was virtually the same. (420 F. Supp. at 1234, 1236; JA 152, 157) Yet each of the four analysts, Sanders, Wien, Clancy, and MacCallum, reached a different conclusion. Sanders confirmed his extant "buy" recommendation and, in fact, his firm bought 850 shares of Bausch & Lomb stock for its discretionary accounts. *Supra*, p. 17. Wien, whose suggestions about the proper methods of promoting Soflens had been rejected by Mr. Schuman, concluded that Bausch & Lomb's management did not have a great deal of creative marketing know-how and strategy, and recommended that Brokaw sell all of its holdings. Clancy, who participated in the same interview with Mr.

Schuman, disagreed with Wien, and recommended that Brokaw retain two-thirds of its holdings. (420 F. Supp. at 1235; JA 154, Ex 75-78) MacCallum concluded that he had learned nothing to dissuade him from following through on his previously reached decision to change his recommendation from a "buy" to a "hold". (420 F. Supp. at 1237; JA 159, 579-581, 584) In sum, the recommendations of the four analysts, after virtually identical interviews with Mr. Schuman, included virtually every possible alternative—buy, sell, hold and sell some but hold more. It is not surprising, then, that Judge Ward rejected the Commission's contentions and found that Mr. Schuman did not disclose material non-public information in his interviews with the analysts. (420 F. Supp. at 1236-37; JA 155, 157-160)

The MacCallum Telephone Call

The main thrust of the Commission's attack, at Judge Ward correctly observed, has been directed at the events of the afternoon of March 16, 1972. (420 F. Supp. at 1237; JA 160)

Upon leaving Mr. Schuman shortly after 11:00 A.M., MacCallum telephoned Hoitsma, pursuant to the prearranged plan. He told Hoitsma that he was reducing his earnings estimates for Bausch & Lomb from 90 cents to 60 to 70 cents per share for the first quarter of 1972 and from \$6.00 to \$4.00 per share for the year; that he was withdrawing his buy recommendation; and that he would be taking the next plane back to New York and would be available that afternoon for a sales meeting. (420 F. Supp. at 1237; JA 160, 468-70, 478, 518-19) As discussed above, MacCallum's estimates were not the product of anything he learned from Mr. Schuman, and he did not attribute any information to Mr. Schuman in his call to Hoitsma. (*Ibid.*)

After meeting with MacCallum, Mr. Schuman attended a board meeting at a Rochester bank. As he left the board meeting shortly before 2:00 P.M. he learned that there had been heavy trading that morning in the shares of Bausch & Lomb common stock on the New York Stock Exchange. He attributed the trading primarily to the Warner-Lambert press release of the previous afternoon. (JA 386-89)

Upon returning to Bausch & Lomb's offices at approximately 2:00 P.M., Mr. Schuman was told by Jack Harby, Bausch & Lomb's president, that Mr. Harby had received a telephone call which reported a rumor that Mr. Schuman had given a first quarter earnings estimate of 60 cents per share to an analyst from FDS. (420 F. Supp. at 1237-38; JA 160, 92 ¶ 53)

The rumor was false and plainly impugned Mr. Schuman's integrity. Mr. Schuman was understandably upset. He had not given MacCallum an earnings estimate when they met that morning (420 F. Supp. at 1236; JA 158) and his practice, as we have seen, was not even to comment on analysts' numbers, much less to disclose his own estimates. Moreover, Mr. Schuman knew that the estimate of 60 cents attributed to him was incorrect and misleading, as he had received an internal earnings estimate for the first quarter of 74 cents per share from Bausch & Lomb's controller on March 13, 1972, just three days before. (JA 90-91 ¶ 47)

Mr. Schuman immediately decided to release publicly Bausch & Lomb's estimate for the first quarter. (420 F. Supp. at 1238; JA 160, 392; *see* JA 92 ¶ 53) He decided also to call FDS to determine whether FDS was in fact attributing an estimate to him. Mr. Schuman accordingly directed his secretary to ask Bausch & Lomb's financial officers to come to his office, and asked her to place a call to

MacCallum's office at FDS. (420 F. Supp. at 1238; JA 160, 92 ¶ 53, 269)

The call to MacCallum's office at FDS was placed at 2:24 P.M. and was completed before Bausch & Lomb's financial officers reached Mr. Schuman's office. (420 F. Supp. at 1238; JA 160, 92 ¶ 53) Since MacCallum had left Rochester only a short time earlier, Mr. Schuman did not expect to speak with him. Nevertheless, his call reached MacCallum and Mr. Schuman spoke to him. (420 F. Supp. at 1238; JA 161, 92 ¶ 53)

Mr. Schuman told MacCallum that Bausch & Lomb had heard that FDS was saying that Mr. Schuman had given MacCallum an earnings estimate for the first quarter. MacCallum denied that he had attributed the estimate to Mr. Schuman but said that FDS was using MacCallum's own earnings estimate of 60 cents per share for Bausch & Lomb earnings for the first quarter. Mr. Schuman reacted with the statement that the 60 cent estimate was low and that 70 to 80 cents per share was more like it. (420 F. Supp. a 1238; JA 161, 92 ¶ 53)

Mr. Schuman did not intend to release an earnings estimate to MacCallum when he placed the call to the FDS office. (JA 391; *see* JA 188) As the trial court found, he did not intend to give MacCallum or anyone else an unfair trading advantage. (420 F. Supp. at 1241-43 and n. 4; JA 169-72, 185-89) He was acting under the extraordinary pressure of a unique set of circumstances, including the false rumor that he had given MacCallum an earnings estimate that morning, months of false rumors concerning the safety of Soflens, rumors concerning possible competition in the Soflens area—culminating the night before in the Warner-Lambert release, and his awareness that these false rumors were seriously disrupting Bausch & Lomb's efforts to market its most important product. When he

heard MacCallum's incorrect estimate, in his own words, Mr. Schuman's estimate "popped out":

"I was agitated. I was extremely agitated when Mr. Harby told me that—what he did—I don't have to repeat all that—and I was—I instantly decided that I was going to go with a number.

"That is why I called our financial people down. I certainly didn't expect to talk to MacCallum. I certainly didn't expect to—obviously it was the furthest thought from my mind to give a number to MacCallum at that point.

"I certainly was agitated, but I felt before talking to the Wall Street Journal, because I also had made up my mind I was going to the Wall Street Journal route as the fastest route, and it was just a—I was moving very fast, I was very intense about it. I don't know that I can really rationalize what I did. It popped out. Why it popped out has of course been plaguing me, because it has been contrary to everything I did. I have had a lot of consequences from this.

"It seemed to me terribly ironic that of all people that this should happen to me.

"I was trying to be very careful. I knew I was dealing with a very, very sensitive situation. I wouldn't let anybody handle it, not because I enjoyed it or wanted to have any ax to grind or any benefit. I knew the company had a severe problem and I really thought I could handle it.

"I have been trying to rationalize it. Maybe what you said yesterday was the answer. I don't know; you know, the 'up periscope'.

"I don't think there is any—maybe I rationalize it another way. I knew I was going public. Maybe that had some effect on me. I don't know. I didn't expect to talk to MacCallum. I guess maybe that

partly threw me. And he said, '60 cents.' I just kind of responded.

"What else can I say, your Honor?" (420 F. Supp. at 1241 n. 3; JA 184-85, 392-93)

While Mr. Schuman was still on the telephone with MacCallum, Bausch & Lomb's financial officers, whom he had summoned earlier, arrived. After the end of the telephone conversation, Mr. Schuman told them that he was going to release an earnings estimate for the first quarter of 1972 of 70 cents to 80 cents per share. They informed Mr. Schuman that they were more comfortable with a range of 65 to 75 cents per share. (420 F. Supp. at 1238; JA 161, 93 ¶ 54, 274-75) Mr. Schuman immediately placed a second telephone call to MacCallum in order to correct the earlier estimate. (420 F. Supp. at 1238; JA 161, 93 ¶ 55, 275)

Very shortly after the second telephone call to MacCallum, Mr. Schuman telephoned Dan Dorfman, a Dow Jones staff reporter and *Wall Street Journal* columnist, and released to him for publication the 65 to 75 cents per share estimate for Bausch & Lomb first quarter earnings. (420 F. Supp. at 1238; JA 161, 93 ¶ 56) Mr. Schuman believed the release of the estimate through Dorfman to be the fastest, most effective manner of publishing the information under the circumstances. (420 F. Supp. at 1238, 1242; JA 161, 172, 392-93) He also explained to Dorfman the sequence of events of that day. (JA 277-80) While he knew that the 65 to 75 cents first quarter estimate would be reported by Dorfman, he was concerned as to how Dorfman would report the fuller story of why and when the estimate was disclosed, since his statements had been garbled by the *Wall Street Journal* before. (JA 279-80; *see* 420 F. Supp. at 1229; JA 144)

After he released the earnings estimate to Dorfman for publication, Mr. Schuman accepted a number of telephone

calls from members of the investment community. (420 F. Supp. at 1238; JA 161, 396-97) All of the telephone calls, with one possible exception, took place after the close of the New York Stock Exchange at 3:30 P.M., Eastern Standard Time. (420 F. Supp. at 1238; JA 162, 397) Mr. Schuman did not realize that Bausch & Lomb's stock was traded on the Pacific Stock Exchange, since he had specifically declined to list the stock there. (420 F. Supp. at 1238; JA 162, 398-99, 435) He told the callers that he had given the 65 to 75 cent estimate to the *Wall Street Journal* and that he expected it to be reported there the following morning. (420 F. Supp. at 1238; JA 162, 396-97) Thus, he neither intended nor anticipated that any of them would or, indeed, could trade on the basis of that information. Nor has the Commission ever contended that any of the persons with whom he spoke did purchase or sell Bausch & Lomb stock as a consequence of these conversations.

The next day, March 17, Bausch & Lomb's 65 to 75 cents first quarter earnings estimate did appear in Dorfman's *Wall Street Journal* column. (Ex 19) The article, however, incorrectly reported that Mr. Schuman had released that estimate to MacCallum during their meeting in Rochester on March 16.

At about 2 P.M. on March 17, Bausch & Lomb issued a press release describing the events of the preceding day and correcting the Dorfman article. (Ex 20)

Market Activity in Bausch & Lomb—
March 16-17, 1972

The Commission contends that the market activity in Bausch & Lomb stock on March 16 demonstrates the materiality of the information disclosed by Mr. Schuman on March 15 and 16. The Commission, however, omits crucial facts which demonstrate that trading on that day was the result of factors other than any information disclosed by

Mr. Schuman, and which fully support the trial court's conclusion that this was an inappropriate case in which to infer materiality on the basis of market activity. (420 F. Supp. at 1236-37, 1239; JA 158-59, 164-65)

On March 16, 1972, 348,000 shares of Bausch & Lomb stock were traded on the New York Stock Exchange. (Ex 399-400) The Commission fails to advise the Court that 100,000 of those shares, almost one-third of the total volume, were sold by a single investor solely on the basis of the Warner-Lambert release of March 15 and its threat of substantial competition to Bausch & Lomb. It is uncontradicted, and the trial court found, that Ronald LaBow sold approximately 100,000 shares of Bausch & Lomb on the morning of March 16, 1972, because the Warner-Lambert announcement—the first announcement directly from the company itself—in LaBow's own words, "scared the heck out of me." (420 F. Supp. at 1239; JA 164; Ex 445-446) And if it "scared the heck" out of LaBow, it undoubtedly "scared the heck" out of others—a conclusion supported by the fact that over 77 percent of the total volume in Bausch & Lomb on March 16 was traded by 12 noon. (Ex 399)

Similarly, the Commission ignores the fact, as reported on the Reuters wire, that "Earlier in the week, a congressional source said that a Senate panel has started a preliminary investigation into the marketing of the new soft contact lens produced by Bausch & Lomb. Several analysts said this development tended to dampen investor sentiment for the issue." (Ex 398; *see* 420 F. Supp. at 1239; JA 164) These two developments, coupled with the "'dark cloud' which hung over Bausch & Lomb at this time", negate any inference that the trading was a result of the disclosure of material, nonpublic information. (420 F. Supp. at 1237, 1239; JA 159, 164)

Unsuccessful in justifying a general inference that the trading on March 16 was a result of the disclosure of any information by Bausch & Lomb or Schuman, the Commission similarly failed to establish that any specific sale was made on the basis of nonpublic corporate information. The trial court specifically found that the Brokaw sale of 72,000 shares was not based on material, nonpublic information. (420 F. Supp. at 1235; JA 154-155) Instead, the evidence established that it was based upon Wien's independent analysis of public facts and his lack of confidence in Bausch & Lomb's management. (420 F. Supp. at 1235-36; JA 154-155, Ex 75-78, 82-84, 90-91)

Similarly, the uncontradicted testimony established that Hoitsma's sale was based on MacCallum's changed evaluation—a change that was made (but not announced) well before MacCallum travelled to Rochester to interview Mr. Schuman. (420 F. Supp. at 1236, 1237; JA 156, 159, 485) It is not surprising that the announcement of the withdrawal of a "buy" recommendation by one of the leading analysts who had staunchly recommended the purchase of Bausch & Lomb would lead to sales of Bausch & Lomb stock by a trading partner in his own firm. Earlier, when Smith, Barney had announced a similar change in recommendation, the price of Bausch & Lomb stock had fallen 17 points. (Ex 417)

Finally, as the trial court found, the Commission did not prove that anyone traded upon the information disclosed to MacCallum in the afternoon telephone calls. (420 F. Supp. at 1239; JA 165) Moreover, the volume of trading following Mr. Schuman's telephone calls to MacCallum was virtually negligible. (Ex 399)

On March 17, 1972, Bausch & Lomb stock did not open for trading on the New York Stock Exchange because of an influx of sell orders. (420 F. Supp. at 1238; JA 162, JA 94

¶ 61) Mr. Schuman and Bausch & Lomb cooperated fully with the New York Stock Exchange in drafting a press release containing the 65 to 75 cent first quarter earnings estimate and information relating to Soflens sales. (*See* 420 F. Supp. at 1238; JA 162, 287-88) The release was completed and issued at approximately 2:00 P.M. (420 F. Supp. at 1238; JA 162, 94 ¶ 61)

Contrary to the Commission's suggestion, the trial court was not bound to attribute the decline in the price of Bausch & Lomb stock on March 20,* when trading resumed, to any disclosures by Mr. Schuman. During the weekend of March 18-19, investors across the country were inundated with press reports of the Commission's investigation of trading in Bausch & Lomb on March 16, of FDS's removal of its buy recommendation, and of the continued slide of Bausch & Lomb under headlines such as *SEC Examining B&L Nosedive* (Ex 404), *SEC Greasing Skids of Bausch & Lomb* (Ex 408) and *Probe Reports Hurt Bausch & Lomb.* (Ex 410; *see also* Ex 405-12, 413) Investors quite naturally could be expected to show a certain lack of enthusiasm for Bausch & Lomb stock in the face of such publicity.

The Lack of Any Insider Trading

Of enormous significance in this case is the fact that it did not involve any trading, or any other attempt to profit, by Bausch & Lomb or Mr. Schuman, or any other officer or director of Bausch & Lomb. During the period February 10 through March 20, 1972, neither Mr. Schuman nor any other officer or director of Bausch & Lomb sold shares of Bausch & Lomb, whether such shares were held

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* On March 20, Bausch & Lomb stock opened at $110, down 15¼ points from the March 16 close of $125.25, and closed at $105. (420 F. Supp. at 1238; JA 162; Ex 418)

in his own right or as beneficial owner within the meaning of the Securities Exchange Act of 1934. In fact, Mr. Schuman never has sold any Bausch & Lomb stock. (JA 94-95 ¶ 63)

The Events Since March 16, 1972

As the trial court suggested, no one who was in the courtroom and observed Mr. Schuman's demeanor and heard his testimony could doubt that he deeply regrets the inadvertent slip that led to this suit. (*See* 420 F. Supp. at 1241; JA 170, 394) Promptly after this episode, both Mr. Schuman and Bausch & Lomb adopted a detailed policy regarding the disclosure of information concerning Bausch & Lomb which prevented—and has continued to prevent—any even arguably improper conduct in the four years between March 1972 and the trial. Indeed, in an effort to avoid any even questionable conduct, Bausch & Lomb and Mr. Schuman have gone well beyond the requirements of the securities laws and the Commission's own pronouncements on discussions with analysts and other members of the investment community.

The trial record showed that Mr. Schuman no longer met with or took calls from analysts. In fact, he had spoken to analysts only once between March 16, 1972 and the trial —at a public meeting of the New York Society of Financial Analysts attended by the press. (JA 399) Only designated Bausch & Lomb representatives are permitted to speak with members of the investment community, and they are not permitted to discuss any information which the Company has not previously published in a quarterly report, annual report, press release or product bulletin, irrespective of materiality. (JA 400-07) In addition, the company constantly reviews internal information to determine whether public disclosure is appropriate. All doubts are resolved

in favor of issuing a press release and public disclosure. (JA 401, 404, 408-09) These policies are reviewed regularly with Bausch & Lomb's corporate staff, and it is Bausch & Lomb's intention that these policies continue. (JA 404, 413, 440)

Actions speak louder than words. Mr. Schuman and Bausch & Lomb's policies, adopted in a sincere effort to avoid any improper conduct, have done so. The trial court properly concluded that there was not a single violation in the four years since the events of March 16, 1972. Indeed, with one insignificant, even silly, exception, the Commission never claimed otherwise. (*See infra*, p. 50) On this record, the conclusion that Mr. Schuman and Bausch & Lomb will not violate the securities laws in the future, injunction or no injunction, is inescapable.

Prior Proceedings in This Court

On December 30, 1976, the Commission moved for summary reversal of the judgment below. It asserted that this Court held in *SEC* v. *Universal Major Industries Corp.*, 546 F.2d 1044 (2d Cir. 1976), that the Commission need not establish *scienter* in order to obtain an injunction in a Rule 10b-5 case and that the decision below therefore could not stand.

As we demonstrated on the motion and show again below, *Universal Major Industries* held no such thing. The motion was argued before Judges Feinberg, Gurfein and Meskill on February 8, 1977 and was denied from the bench.

ARGUMENT

I

The Trial Court Correctly Found That There Is No Reasonable Likelihood of Any Future Violation

Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d), governs SEC applications for injunctive relief. It provides in pertinent part:

> "Wherever it shall appear to the Commission that any *person is engaged or is about to engage in* acts or practices constituting a violation of any provision of this chapter, [or] the rules . . . thereunder, . . . it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices, and *upon a proper showing* a permanent or temporary injunction or restraining order shall be granted without bond." (Emphasis supplied)

The "proper showing" required by the Act is proof of a reasonable likelihood of future violations of the securities laws. *SEC* v. *Universal Major Industries Corp., supra,* 546 F.2d at 1048 (2d Cir. 1976); *SEC* v. *Management Dynamics, Inc.,* 515 F.2d 801, 807 (2d Cir. 1973); *SEC* v. *Spectrum Ltd.,* 489 F.2d 535, 542 (2d Cir. 1973); *SEC* v. *Manor Nursing Centers, Inc.,* 458 F.2d 1082, 1100 (2d Cir. 1972). *SEC* v. *Bangor Punta Corp.,* 331 F. Supp. 1154 (S.D.N.Y. 1971), *aff'd sub nom. Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.,* 480 F.2d 341, 385 (2d Cir.), *cert. denied,* 414 U.S. 924 (1973) ("propensity or natural inclination to violate the securities laws").

As Judge Learned Hand wrote in *Ring* v. *Author's League of America,* 186 F.2d 637, 642-43 (2d Cir. 1951):

> "Even when the plaintiff is the United States or one of its administrative agencies, and the suit is therefore brought in the public interest, or at least in the interest of a class, *there must be some tangible probability that the wrong will be repeated to justify an injunction.*" (Emphasis supplied) (Footnote omitted)

The trial court, after a full trial and careful analysis of the facts, found that there is no reasonable likelihood that these defendants will violate the securities laws in the future, and it therefore denied the Commission's application for an injunction. That finding is fully supported by the record, surely is not clearly erroneous and, indeed, is not here challenged by the Commission.* The court below plainly applied the correct legal standard. The judgment therefore should be affirmed.

A. There Was No "Pattern" of Disclosure Improprieties Which Compelled an Inference that Future Violations are Likely

The Commission seeks to create the impression that there was a "pattern" of improper disclosures by Mr. Schuman and Bausch & Lomb. Doubtless it hopes thereby to gain a sympathetic ear for its plea for an advisory opinion on the *Ernst & Ernst* issue. But the record is plain that the Commission failed to establish any "pattern" of improprieties below. There was one questionable act—the inad-

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* Since the Commission does not challenge this ultimate finding, the case is moot. In the absence of a dispute as to whether there is a reasonable likelihood of a future violation—the *sine qua non* of an injunctive action—the Commission simply has no controversy with these defendants. *See United States* v. *W. T. Grant Co.*, 345 U.S. 629, 632-33 (1953); *Link* v. *Mercedes Benz*, 550 F.2d 860, 864-65 (3d Cir. 1977); *Cover* v. *Schwartz*, 133 F.2d 541, 544-46 (2d Cir.), *cert. denied*, 319 U.S. 748 (1942). Accordingly, the appeal should be dismissed as moot. *Cover* v. *Schwartz, supra*, 133 F.2d at 546.

vertent disclosure of the earnings estimate in the telephone call to MacCallum on the afternoon of March 16, 1972. The trial court concluded that neither that act, nor any of the other events relied upon by the Commission, established a reasonable probability of future securities law violations. The record demonstrates that its conclusion was not only within the broad limits of its equitable discretion, which is the standard of review here,* but eminently correct.

1. *The Disclosure of the Earnings Estimate Was Inadvertent*

Based upon Mr. Schuman's testimony and demeanor during his lengthy examination (420 F. Supp. at 1241; JA 170), as well as substantial extrinsic evidence, the trial court found that Mr. Schuman's disclosure of the earnings estimate in the call to MacCallum on March 16 was an "uncharacteristic and inadvertent" slip. (420 F. Supp. at 1242; JA 171) The trial court plainly had ample basis for its finding.

On the afternoon of March 16, 1972, Mr. Schuman was acting under great pressure engendered in part by his having heard a rumor that MacCallum was falsely attributing a specific and erroneous earnings estimate to him and by his knowledge that there was unusual market activity in Bausch & Lomb. (420 F. Supp. at 1237-38; JA 160, 92 ¶ 53, 368-89) He decided to go public with the correct earnings estimate and to call MacCallum's office to stop a false rumor that impugned his integrity and that was liable to affect the market.** (420 F. Supp. at 1243-44 n. 4;

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* *Infra*, pp. 54-55.

** There certainly was nothing wrong with Mr. Schuman's deciding to release Bausch & Lomb's internal estimate to the public or to tell

(footnote continued on following page)

JA 188-89) Certainly Mr. Schuman did not intend to reveal an earnings estimate when he placed the call to the FDS office, much less to give MacCallum or his customers any trading advantage. (420 F. Supp. at 1241-44; JA 170-73, 185-89) When he heard MacCallum's incorrect estimate, his own estimate simply "popped out". (420 F. Supp. at 1243 n. 4; JA 188)

The trial court found that Mr. Schuman did not intend to deceive, defraud or manipulate by the MacCallum disclosure. (420 F. Supp. at 1241-44; JA 170-72, 185-89) He did not act recklessly. (420 F. Supp. at 1241-44 n. 4; JA 185-89) He did not act out of selfish motives. (JA 94-95 ¶ 63) Indeed, since his estimate was slightly higher than MacCallum's—which already had been disseminated and falsely attributed to Mr. Schuman—the disclosure itself was of less significance than might normally be the case in the disclosure of a corporate earnings estimate. (420 F. Supp. at 1243 n. 4; JA 188-89) Moreover, immediately after the inadvertent disclosure to MacCallum, Mr. Schuman hastened to disseminate the earnings figure to the media in what he believed to be the fastest possible method. (420 F. Supp. at 1242; JA 172) While a better means of disclosure perhaps was available, the trial court found that Mr. Schuman's haste to disseminate the leaked earnings figure belied any intent to deceive or defraud or recklessness bordering on such intent. (*See* 420 F. Supp. at 1242 and n. 4; JA 172, 185-89)

FDS that the rumor he had heard was false and FDS's earnings estimate wrong. The trial court noted that such action "[a]t least arguably [served] a legitimate corporate purpose", and it quoted the advice of then General Counsel Loomis, in his interview before the Financial Analysts Federation (420 F. Supp. at 1243 n. 1; JA 188; Ex 242):

> "I do feel that a service might be done by corporate management in calling attention through the appropriate channels to the institution whose forecasts have been circulated around the market that, in the opinion of management, that is just plain wrong."

2. *The Analyst Interviews of March 15-16*

The Commission contended that Mr. Schuman conveyed material nonpublic corporate information in his interview with Clancy and Wien on the afternoon of March 15, 1972 and his interview with MacCallum the following morning.* During those interviews, which were conducted pursuant to the "open door" policies of the Commission and the New York Stock Exchange, Mr. Schuman responded to inquiries of sophisticated securities analysts knowledgable about the affairs of the company. With each question, and each comment by the analysts, Mr. Schuman was required to make and did make an instant and immediate judgment about the appropriate scope of disclosure.

The Commission challenged his judgment. Four years later, the trial court, after hearing days of testimony, reviewing hundreds of pages of exhibits, assessing the available guidance from the Commission, and considering the dozens of cases cited by the parties, reached the same conclusion that Mr. Schuman had reached during the course of the interviews. The trial court found that the remarks made by Mr. Schuman did not rise to the level of disclosure of material nonpublic information (420 F. Supp. at 1235; JA 155) and did not constitute anything

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* The personal conversations between Mr. Schuman and the analysts in Rochester could not be the basis for a § 10(b) or Rule 10b-5 violation: the court lacked jurisdiction for lack of the "use of any means or instrumentality of interstate commerce. . . ." 15 U.S.C. § 78j(b). Here, the only use of an instrumentality of interstate commerce was the analysts' calls to Mr. Schuman's secretary to schedule appointments with him. While telephone calls by the defendant which are connected to the transaction complained of may provide a basis of federal jurisdiction, the connection between these telephone calls and the alleged violations are too tenuous and indirect to satisfy the jurisdictional requirements of the statute. *See Boone* v. *Bough*, 308 F.2d 711, 713 (8th Cir. 1962); *compare with Matheson* v. *Armbrust*, 284 F.2d 670, 673 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961); *Aquionics Acceptance Corp.* v. *Kollar*, 503 F.2d 1225 (6th Cir. 1974).

beyond links in a chain of analytical information. (420 F. Supp. at 1237; JA 159-160) The Commission, relying more upon its allegations than either the evidence or the court's findings, asserts here that, because the Court rejected its contentions, it must have applied an erroneous standard of materiality. In fact, however, Judge Ward carefully and correctly discussed and relied upon precisely the same legal principles and precedents on which the Commission now purportedly relies.

The governing standard of materiality in a Rule 10b-5 case is whether the particular information would have been important to a reasonable investor in determining whether to buy, sell or hold a security. *See Santa Fe Industries, Inc.* v. *Green*, 97 S. Ct. 1292, 1301 n. 14 (1977); *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir.), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969). As the trial court noted, the Supreme Court recently examined the concept of materiality in the context of the proxy rules promulgated under the 1934 Act. In *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976), also relied upon by the Commission (SEC br. 66-67), the Supreme Court stated:

> "What the standard [of materiality] does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted facts would have assumed actual significance in the deliberations of the reasonable shareholders. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (420 F. Supp. at 1234 n. 2; JA 183-84)*

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* As the Commission notes (SEC br. p. 68), the Supreme Court in *TSC Industries, Inc.* expressed concern that too low a threshold of

(footnote continued on following page)

Thus, as the trial court stated, "the standard of materiality should not be unduly hypothetical or speculative"; whether particular facts are material must be determined on a case-by-case basis, in light of all the circumstances surrounding the transaction, including the total amount of information available. (420 F. Supp. at 1234; JA 151) *See, e.g., TSC Industries, Inc.* v. *Northway, Inc., supra,* 426 U.S. at 448-49; *SEC* v. *Geon Industries, Inc., supra,* 531 F.2d at 47; *SEC* v. *Shapiro,* 494 F.2d 1301, 1306 (2d Cir. 1974); *Spielman* v. *General Host Corp.,* 402 F. Supp. 190, 194-95 (S.D.N.Y. 1975), *aff'd,* 538 F.2d 39 (2d Cir. 1976). Rule 10b-5 does not create violations for "omissions of a trivial nature." *McLean* v. *Alexander,* 420 F. Supp. 1057, 1075 (D. Del. 1976). To the contrary, as the courts, and the Commission itself have recognized, material informa-

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materiality might encourage management to bury shareholders "in an avalanche of trivial information" rather than further the fundamental interest of the securities laws in meaningful disclosure. *TSC Industries, Inc.* v. *Northway, Inc., supra,* 426 U.S. at 448-49. Precisely the same concern applies in cases, such as this one, which are based on communications between corporate management and securities analysts. Such contacts, and the discussion of pieces of information which are too unimportant to justify a press release or other public announcement, but are necessary grist for the analysts' analysis, maximize the flow of corporate information and evaluation to the capital markets and thus further the goal of informed investment decisions. *See Matter of Investors Management Co., supra,* [1970-1971 Transfer Binder] FED. SEC. L. REP. ¶ 78,163 at 80,521; Loomis Interview (JA 177, 179, Ex 228, 232, 234, 247); Smith 1968 Speech (JA 181-182, Ex 256, 259); *see generally*: Solomon and Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventive Guidelines and Proposals for Reform,* 43 FORDHAM L. REV. 505 (1975); *New Guidelines On Inside Information,* FINANCIAL ANALYSTS JOURNAL 20 (Jan./Feb. 1974). Too low a threshold of materiality would create intolerable risks for corporate executives in speaking with analysts and would discourage, rather than encourage, good analysis and the flow of information to the investing public.

tion is essentially information which is extraordinary in nature.*

The thrust of the Commission's legal argument appears to be twofold. First, the Commission claims that the trial court erroneously ignored the objective standard of the reasonable investor when it considered the testimony of Mr. Schuman and the analysts with whom he met on March 15 and 16 with respect to the significance of the information discussed. (420 F. Supp. at 1235-36; JA 154-55, 157-58) The Commission argues that the trial court found certain Soflens sales information to be immaterial or public because the analysts to whom the disclosures were made already were aware of the information. Second, the Commission appears to argue that the trial court found that certain new product information was not material because it erroneously concluded that the information already had been sufficiently publicly disseminated by Bausch & Lomb in letters to Bausch & Lomb customers.

The Commission's arguments are based upon a tortured misreading of the district court decision. In determining whether any of the facts disclosed during the analyst interviews of March 15 and 16 were material, the trial court did apply the objective standard of whether a reasonable investor would have attached significance to the particular fact. (420 F. Supp. at 1233-34; JA 150-51) In making

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* *E.g., SEC* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d at 848 ("An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in 'those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed.'"); *Matter of Investors Management Co., supra,* [1970-1971 Transfer Binder] FED. SEC. L. REP. ¶ 78,163 at 80,519; (420 F. Supp. at 1234; JA 151) ("The information's significance was immediately clear; it was not merely one link in a chain of analytical information.")

that determination, one of the factors which the court considered—although, as the trial court stated, by no means a "dispositive" factor (420 F. Supp. at 1235; JA 154)—was the importance attached to the information by those who knew about it. This has long been considered an important factor in determining whether a particular fact is material. *SEC* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d at 851; *Mittendorf* v. *J. R. Williston & Beane, Inc.,* 372 F. Supp. 821, 828 (S.D.N.Y. 1974). It ill behooves the Commission, which both here and below has argued that materiality should be inferred from the conduct of the analysts who met with Mr. Schuman, to claim that the district court committed reversible error by considering the analysts' reactions to the information discussed with Mr. Schuman in judging its materiality.

Nor did the court conclude that the information concerning Soflens sales was not material because the analysts with whom he spoke already were aware of such information. The court concluded that such information was not material in the context of what "was general knowledge among those in the investment community who followed BOL stock." (420 F. Supp. at 1236; JA 157) In doing so, the court simply applied the well-established doctrine that materiality must be determined in the context of the "total mix" of available information. (420 F. Supp. at 1234, 1237; JA 151, 159-60) *Spielman* v. *General Host Corp., supra,* 402 F. Supp. at 195; *see TSC Industries, Inc.* v. *Northway, Inc., supra,* 426 U.S. at 449.

The Commission's final argument also is without merit. The trial court properly considered whether the time of the introduction of the aphakic lens and the Soflens minikit was routine operational information. *See Matter of Investors Management Co., supra,* [1970-1971 Transfer Binder] Fed. Sec. L. Rep. ¶ 78,163 at 80,519. In making

that determination, the court considered evidence that Bausch & Lomb treated the information as a regular marketing matter—the Bausch & Lomb's marketing division had been routinely answering customer inquiries as to the availability of the products with similar information to that discussed by Mr. Schuman. (420 F. Supp. at 1235; JA 153; Ex 421-27) The court's consideration was entirely appropriate. In this regard, the advice of then General Counsel Loomis, when asked whether management could discuss information which had not already been communicated to its stockholders or some broad segment of the public, is relevant:

> "[T]he test that the Stock Exchange suggests is, 'Is this confidential information which the company wouldn't give to a person who came in and asked for it? Are they slipping it to this particular analyst because they expect something in return?' Then, you've got a problem.
>
> "But aside from that, I don't think the mere fact that it has not already been disseminated—perhaps because the company doesn't want to send their stockholders something the size of a telephone book —makes it improper for them to tell an analyst." (JA 177; Ex 247); *see also* Smith 1968 Speech, (Ex 259)

The foregoing demonstrates that the Commission's attack on the legal standard of materiality applied below is but a device designed to avoid the "clearly erroneous" standard mandated by Rule 52. The trial court found that, in light of all the circumstances at the time, a reasonable investor was not likely to attach significance to the matters discussed in the March 15-16 interviews. (420 F. Supp. at 1237; JA 159) This finding, clearly supported by the record, was

uniquely a matter for the trier of fact. As the Supreme Court stated in *TSC Industries, Inc.* v. *Northway, Inc.*, *supra*, 426 U.S. at 450, in reversing summary judgment granted by the Seventh Circuit on the ground that certain facts were material as a matter of law:

> "The determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact."

An experienced trial judge, after careful consideration of the facts, found that none of the information discussed by Mr. Schuman during these interviews was material.* This underscores the fact that Mr. Schuman's conduct did not exhibit the kind of disregard for law that might warrant an injunction. Even if an appellate court, with the benefit of hindsight and with time for study and reflection unavailable to Mr. Schuman when he acted, disagrees with both the trial judge and Mr. Schuman as to where on the "slippery slope of materiality"** such maters as aphakic lenses should be placed, Mr. Schuman's actions in the analyst meetings do not evidence any propensity to violate the securities law.

3. *The Commission's Other Claims*

The Commission's handful of other claims of improprieties, which even the Commission has relegated to a footnote, are frivolous and—to the extent they were raised below —were recognized as such by the trial court. Judge Ward found: "The Commission's efforts to prove 'similar acts'

* The detailed support for this finding is in the attached Annex.

** Sommer, *The Slippery Slope of Materiality*, N.Y.L.J. p. 1 (Dec. 15 and 16, 1975).

were not convincing. The Court finds no pattern of past violations suggesting that defendants should be enjoined." (420 F. Supp. at 1244; JA 174) The court's finding is fully borne out by the record.

First, the Commission claims that Mr. Schuman disclosed a nonpublic earnings estimate to MacCallum in October, 1971.* (SEC br. 65 n. 108) This claim was completely deflated at trial. Mr. Schuman testified that his established practice was not to give company earning estimates to analysts (JA 298-99, 303-04)—a practice which the trial court found was recognized by the analysts. (420 F. Supp. at 1242; JA 170-71) The Commission's sole "evidence" of this alleged disclosure was an unsworn statement made by MacCallum to the SEC, outside the presence of defense counsel, well after the events and long before trial. (JA 542) At trial, MacCallum neither recalled the alleged conversation with Mr. Schuman nor whether the conversation was fresh in his memory at the time he made the statement to the Commission. (JA 542; Trial Transcript 497-98) Moreover, MacCallum confirmed at trial the truth of his sworn statements to the New York Stock Exchange *on March 17, 1972* that "Bausch & Lomb has not discussed earnings with me since I began following the company. B&L has been very leery about discussing earnings . . . ." (JA 617-18) and that Mr. Schuman "would not talk about earnings of the company". (JA 621) It is hardly surprising that the trial court credited the live trial testimony of Messrs. Schuman and MacCallum and found that this claim was "not convincing." (420 F. Supp. at 1244; JA 174)

Second, the Commission apparently makes two claims in connection with the March 1 release concerning the tempo-

* The Commission made no such claim in its contentions in the pretrial order. (JA 96-103)

rary interruption in Soflens shipments: It asserts that Mr. Allen improperly disclosed material inside information by confirming the shipping delay in response to the unsolicited call from an analyst which prompted the release. It implies also that Bausch & Lomb issued a press release concerning the shipping delay only at the insistance of the Stock Exchange. (SEC br. 7-8) As we have demonstrated, however, both of these assertions—which were not pressed below—are false. *Supra*, pp. 14-15 n.

Finally, in its only claim of an impropriety in the years since 1972, the Commission attacks a letter Bausch & Lomb's marketing division sent to thousands of practitioners on or about October 4, 1973. (JA 74, 440) Its attack apparently is based on the theory that the letter disclosed material information that first should have been disclosed in a press release. (SEC br. 65 n. 108)

The letter was routine customer correspondence which had nothing to do with securities trading. (*See* JA 289-91) It simply apologized for the company's delay in filling doctors' orders for the lenses and for incidental service difficulties. The letter explained that the delays had resulted from increased demand for Soflens contact lenses and stated that the company hoped to normalize shipments and service shortly. (JA 75) Moreover, when a brokerage firm called to inquire about the letter, Bausch & Lomb immediately issued a press release—not because it regarded the contents as material, but out of an abundance, if not an excess, of caution. (*See* JA 408)

This incident evidences Bausch & Lomb's heightened sensitivity to obligations under the securities laws, rather than any propensity to violate those laws.

* * *

The foregoing demonstrates that there was here no "pattern" of improprieties. The Commission simply failed to establish a single instance of improper conduct by Mr. Schuman or Bausch & Lomb before or after the afternoon of March 16, 1972. (420 F. Supp. at 1244; JA 174) If there was any impropriety at all, it was limited to no more than that a few minutes over 5 years ago and, in any event, was uncharacteristic, inadvertent and clearly regretted. Indeed, as the trial court found on the basis both of contemporaneous analyst reports and the testimony of the Commission's own witnesses, Bausch & Lomb and Mr. Schuman were regarded by analysts as "difficult to communicate with" and Mr. Schuman "certainly never offered information." (420 F. Supp. at 1242; JA 170-71; Ex 39, 44; JA 567)

The trial court's refusal to issue an injunction on the basis of the isolated events of March, 1972 was consistent with past practice in this Circuit. Courts in this Circuit repeatedly have denied applications for injunctions based exclusively on isolated events such as those at bar, even where clear violations of the securities laws had occurred. *See, e.g., SEC* v. *Parklane Hosiery Co.,* [Current] Fed. Sec. L. Rep. ¶ 95,753 at 90,696 (S.D.N.Y. 1971); *SEC* v. *Bangor Punta Corp., supra,* 331 F. Supp. at 1162; *SEC* v. *Harwyn Industries Corp.,* 326 F. Supp. 943, 957 (S.D.N.Y. 1971); *SEC* v. *Texas Gulf Sulphur Co.,* 312 F. Supp. 77, 88-90 (S.D.N.Y. 1970), *aff'd in part and rev'd in part,* 446 F.2d 1301 (2d Cir.), *cert. denied,* 404 U.S. 1005 (1971). In fact, in the leading case of *Texas Gulf Sulphur,* the district court denied injunctive relief sought against several principal offenders on the grounds that the insider trading in question was a "once-in-a-lifetime-affair". *Texas Gulf Sulphur Co., supra,* 312 F. Supp. at 88-90.

B. The Other Circumstances Support the Trial Court's Finding that Future Violations are Unlikely

An abundance of other factors supports the trial court's finding that Mr. Schuman and Bausch & Lomb—both of whom had a reputation for being particularly closemouthed about company affairs—are unlikely to violate the securities laws in the future and, therefore, its refusal to issue an injunction.

First, as we have noted previously, the trial court found that Mr. Schuman did not act out of any improper motive. Not only did Mr. Schuman not intend his actions to confer any trading advantage on anyone, but neither he nor anyone else at Bausch & Lomb traded during the relevant period. (420 F. Supp. at 1241-44; JA 170-73, 185-89, 94-95 ¶ 63)

Second, Bausch & Lomb and Mr. Schuman have adopted effective measures to prevent improper disclosures.

The trial record showed that Mr. Schuman no longer met with or took calls from analysts. In fact, he had spoken to analysts only once between March 16, 1972 and the trial—at a public meeting of the New York Society of Financial Analysts which was attended by the press. (JA 399)

The same sensitivity about the problems of disclosure of material information have shaped and permeated Bausch & Lomb's corporate policies in this area. Under those policies, all calls from security analysts are now referred to the director of corporate communications, who was hired after the events in this case and who has considerable experience in this area. (JA 400, 406-07) If an analyst requests a

personal interview with the company, the company's policy requires that two persons attend that interview, usually the director of corporate communications and the vice president for finance. (JA 400) During these interviews, and during any telephone contacts with analysts, the Bausch & Lomb personnel are not permitted to discuss any matter which has not previously been published by the company through a quarterly report, annual report, press release or product bulletin. (JA 400-01, 405-06) That policy is designed to eliminate the difficult questions of judgment in determining materiality by forbidding all discussion of subjects not previously put in the public record by Bausch & Lomb. (JA 405) Bausch & Lomb's conservative policies of refusing to discuss any matter which it has not made public go beyond the requirements of the securities laws and are designed to avoid even questionable conduct.

In addition, the company constantly reviews internal information to determine whether public disclosure is appropriate. In the Soflens division, for example, the company has hired special inside counsel. He reviews every piece of paper leaving the Soflens division. If there is anything at all questionable, in the sense that it is conceivably appropriate for a press release, the matter is referred to Mr. Schuman at corporate headquarters who discusses the matter with a corporate group, including inside counsel and outside counsel, to determine whether or not a press release should be issued. All doubts are resolved in favor of issuing a press release and public disclosure. (JA 401,404, 408-09)

The importance of this general subject is reviewed with the officers of the company regularly so that the corporate staff is extremely sensitive to the importance of complying with the company's policy concerning disclosure. As new people join the Bausch & Lomb corporate staff, they are

similarly made aware of the current company policies. It is Bausch & Lomb's intention that these policies continue. (*See generally* JA 400-01, 405-07, 413, 435-40)

C. The Trial Court Considered the Appropriate Factors and Properly Denied an Injunction

In concluding that there is no likelihood of future violations in denying an injunction, the trial court considered the inadvertent and isolated nature of the events relied upon by the Commission, the lack of any improper motives on the part of Bausch & Lomb and Mr. Schuman, the effective measures both have taken to prevent any future violations, and the court's own assessment of Mr. Schuman and his sincerity based on its observation of his demeanor. These factors are precisely those which this Court has held are material. In *Universal Major Industries Corp., supra*, 546 F.2d at 1048, for example, the Court stated:

> "The factors which [the trial court] may consider [in determining whether to issue an injunction] include the likelihood of future violations, the degree of scienter involved, the sincerity of defendant's assurances against future violations, the isolated or recurrent nature of the infraction, defendant's recognition of the wrongful nature of its conduct, and the likelihood, because of defendant's professional occupation, that future violations might occur."

Accord, SEC v. *Management Dynamics, Inc., supra,* 515 F.2d at 807; *SEC* v. *Spectrum, Ltd., supra,* 489 F.2d at 542; *SEC* v. *Manor Nursing Centers, Inc., supra,* 458 F.2d at 1101-02. Hence, the trial court committed no error of law in denying the injunction.

The same cases establish also that the trial judge "is vested with a wide discretion when an injunction is sought to prevent future violations of the securities laws . . ."

Universal Major Industries Corp., supra, 546 F.2d at 1048. The party seeking to reverse the trial court's exercise of discretion "has the burden of showing that the court abused that discretion, and the burden necessarily is a heavy one." *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1100. The trial court's finding that neither Mr. Schuman nor Bausch & Lomb is likely to violate the securities laws in the future in the absence of an injunction was fully supported by the record, and the court's conclusion that the issuance of an injunction was not warranted was mandated by that finding. The trial court plainly did not abuse its discretion, and the judgment below therefore should be affirmed.

II

The Trial Court's Discussion of *Ernst & Ernst* Was Dictum and, In Any Event, Correct

The *Ernst & Ernst* question so vigorously pressed on this Court by the Commission has no proper bearing on the disposition of this appeal. The trial court denied an injunction on the basis of its eminently sound finding that neither Mr. Schuman nor Bausch & Lomb is likely to violate the securities laws in the future. While it found no past violation of law, it held that it would have denied an injunction in any event. (426 F. Supp. at 1244; JA 174) And since even a finding of a past violation would not have required issuance of an injunction,* the dispositive issue here is whether Judge Ward abused his broad discretion in declining to enjoin Mr. Schuman and Bausch & Lomb. Plainly he did not. But more important for present purposes is that whether Judge Ward's *dicta* on the *scienter* point are right or wrong is immaterial here; whichever way that dispute ultimately is resolved will not affect the result in this case. Hence, the Court should not accede to the Commission's plea for an advisory opinion.

While there is no need for the Court to deal with the question—and sound reasons why it should not**—we submit that Judge Ward's discussion of *Ernst & Ernst* was correct. He discussed the state of Mr. Schuman's mind for two reasons. First, he considered Mr. Schuman's state of mind in determining whether there was a likelihood of future violations. Second, the Commission insisted below —as it does here—on an advisory opinion as to whether

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* *SEC* v. *Management Dynamics, Inc., supra,* 515 F.2d at 807.

** *See, e.g., Muskrat* v. *United States,* 219 U.S. 346, 356-62 (1911).

the events of March, 1972 constituted a violation of Rule 10b-5. In satisfying the Commission's request—although the case did not require that the request be satisfied—he properly considered whether the elements of a Rule 10b-5 violation, including *scienter,* were proven. And he was right on both counts.

A. Decisions of this Court Compelled the Trial Court to Consider Mr. Schuman's State of Mind In Deciding Whether to Issue An Injunction

Judge Ward examined Mr. Schuman's state of mind in connection with the events of March, 1972 in order to determine whether it suggested that Mr. Schuman or Bausch & Lomb was likely to violate the securities laws in the future in the absence of an injunction. In concluding that there was no such likelihood, he placed substantial weight on his findings that the disclosure of the earnings estimate to MacCallum was an "uncharacteristic and inadvertent slip", that neither Mr. Schuman nor Bausch & Lomb had sought to profit by misuse of insider information, that Mr. Schuman recognized his error in disclosing the earnings estimate to MacCallum and hastened to "go public" with the relevant information, and that Mr. Schuman conscientiously tried to avoid material disclosures in the analyst meetings, despite the lack of clear guidelines as to proper subjects for discussion. (420 F. Supp. at 1241-44 and nn. 3-4, 1239, 1234-36; JA 169-73, 184-89, 165, 151-58)

The trial court's consideration of Mr. Schuman's state of mind in determining whether he was likely to violate the securities laws in the future was compelled by prior decisions of this Court. It has long been the law in this Circuit that the defendant's past state of mind is highly relevant to determining whether there is a likelihood of future violations. *E.g., SEC* v. *Universal Major Industries*

Corp., supra, 546 F.2d at 1048; *SEC* v. *Management Dynamics, Inc., supra,* 515 F.2d at 807; *SEC* v. *Spectrum, Ltd., supra,* 489 F.2d at 542; *SEC* v. *Manor Nursing Centers, Inc., supra,* 458 F.2d at 1101-02. Proof of deliberate and knowing misconduct in the past may or may not warrant injunctive relief, whereas an isolated and uncharacteristic act of negligence would not.* As Judge Mansfield noted in *SEC* v. *Bangor Punta Corp.*:

> "[T]he lack of [wrongful] intent is an important factor to be considered by the court in assessing the risk of future violations. One who intentionally violates the law or shows a willful disregard for it is usually a poorer risk than one who acts without a full appreciation for the seriousness of his conduct." *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 406 (2d Cir.), *cert. denied,* 414 U.S. 924 (1973) (Mansfield, J., concurring and dissenting). *See SEC* v. *Keller Industries, Inc.*, 342 F. Supp. 654, 659 n. 10 (S.D.N.Y. 1972).

Judge Ward's evaluation of Mr. Schuman's state of mind, among other factors, led him to conclude that Mr. Schuman was not likely to violate the law in the future. Judge Ward, moreover, was in a unique position to judge whether Mr. Schuman had any propensity to violate the law. As Judge Gurfein observed in *SEC* v. *Bangor Punta Corp.*:

> "In the last analysis we are dealing with intent and must seek to determine whether there is a likelihood of recurrence of unlawful activity and a need for a

* Indeed, the pre-*Ernst & Ernst* cases which have stated that negligence is sufficient in an SEC injunction proceeding almost uniformly have involved conduct of a highly fraudulent nature. *E.g., SEC* v. *Shapiro, supra,* 494 F.2d at 1308; *SEC* v. *Manor Nursing Centers Inc., supra,* 458 F.2d at 1101. Where an isolated episode of negligence is involved, on the other hand, injunctions have been found to be unnecessary and have been denied. *Supra,* p. 51.

prophylactic against recidivism. Who is better able to determine such things than the Judge who saw and heard the witnesses and got the feel of what happened?" *Chris-Craft Industries, Inc. v. Piper Aircraft Corp., supra,* 480 F.2d at 394 (Gurfein, J., concurring and dissenting).

Thus, Judge Ward properly considered Mr. Schuman's state of mind in assessing the likelihood of future violations. That he labelled his conclusion in terms of whether or not Mr. Schuman lacked *scienter* is unimportant for this purpose—the important point is that his unique opportunity to evaluate Mr. Schuman's motives and actions persuaded him that no injunction was warranted. The almost theological arguments advanced by the Commission concerning the need for proof of *scienter* and the mental state it describes cannot obscure this simple truth and do not even begin to suggest that Judge Ward abused his discretion in declining to issue an injunction.

B. While the Statements Are Dicta, the Trial Court Correctly Concluded That (1) the Same State of Mind Is Necessary to Establish a Violation of Rule 10b-5 Irrespective of the Identity of the Plaintiff and (2) There Was no Violation Here

The Commission below insisted—as it does here—that it "is entitled at least to an unequivocal finding that the law was violated" in this case, even if it is not entitled to any relief. (SEC br. 26) The trial court—though not required to do so—undertook to give the Commission the ruling it sought. It therefore necessarily considered whether the Commission had established each of the elements of a violation of Section 10(b) and Rule 10b-5 in this case.

1. *The Reasoning of* Ernst & Ernst *Requires the Conclusion That the SEC Must Prove Scienter to Establish a Violation of Section 10(b) or Rule 10b-5*

In *Ernst & Ernst* v. *Hochfelder,* the Supreme Court held that *scienter*—intent to deceive, defraud or manipulate—is an essential element of a violation of Section 10(b) or Rule 10b-5 in an action for damages. 425 U.S. at 193. Although the Court did not have before it a Commission injunction action (*id.* at 194 n. 12), the reasoning of *Ernst & Ernst* requires the conclusion that proof of *scienter* is necessary to establish a violation in a Commission injunction proceeding as well as in an action for damages, and Judge Ward correctly reached that conclusion.

The trial court accurately recognized that the Supreme Court's holding in *Ernst & Ernst* was based on four factors:

> "First, the language of § 10(b) which speaks of 'any manipulative or deceptive device or contrivance,' is plainly directed at intentional wrongdoing. Secondly, the legislative history suggests that § 10(b) was directed at practices involving *scienter*.[*]
>
> "Next, the Court examined other sections of the securities laws, pointing out instances where re-

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* Among the aspects of the legislative history relied upon by the Court was Mr. Corcoran's statement that the provision which became Section 10(b) "says, 'Thou shalt not devise any other cunning devices' . . ." 425 U.S. at 202. As two commentators recently have pointed out, Mr. Corcoran's comments—comments described by the Supreme Court as "most relevant" and "significant" (425 U.S. at 202-03)—were made at a time when "the draftsmen of the 1934 Act did not anticipate that violations of the rules promulgated under Section 10(b) would be subject to private damage actions . . . [Hence,] this legislative history is especially pertinent to the Commission injunctive action—the direct object of congressional consideration." Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal In Light of Hochfelder*, 51 N.Y.U. L. Rev. 769, 776 (1976) (hereinafter "Berner & Franklin").

> covery for negligent conduct was intended and was thus expressly provided and at the same time was circumscribed by certain procedural restrictions. Finally, Rule 10b-5 itself was scrutinized and the conclusion drawn that when promulgated, the Rule was aimed at behavior involving *scienter*." (420 F. Supp. at 1240; JA 167-68)

The trial court's summary of the grounds on which *Ernst & Ernst* was decided is completely accurate. *Ernst & Ernst, supra,* 425 U.S. at 197-214. And the Commission does not contend otherwise.

Judge Ward reasoned that these same considerations of statutory construction that led the Supreme Court to conclude that a Rule 10b-5 violation required proof of *scienter* in a private action apply equally to determining whether a violation of Rule 10b-5 occurred in actions brought by the Commission. (420 F. Supp. at 1240-41; JA 168-69). He plainly was correct in doing so.* *See* Berner & Franklin, *supra,* 51 N.Y.U. L. Rev. 769; Case Comment, *Scienter and SEC Injunction Suits: SEC* v. *Bausch & Lomb, Inc. and SEC* v. *World Radio Mission, Inc.,* 90 Harv. L. Rev. 1018 (1977). Judge Ward did no more than recognize the point made by the Commission

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* Other lower courts have gone both ways on whether *scienter* is necessary to prove a Section 10(b) or Rule 10b-5 violation in the context of an SEC injunction action. In *SEC* v. *American Realty Trust,* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,913 at 91,439-440 and nn. 4-9 (E.D. Va. 1977), the district court carefully considered the analysis employed by the Supreme Court in *Ernst & Ernst* and concluded, as did Judge Ward, that *scienter* is a necessary element of a Rule 10b-5 violation in an enforcement proceeding. In *SEC* v. *Geotek,* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,756 at 90,723-724 (N.D. Cal. 1976), the court held that negligence was sufficient, relying upon pre-*Ernst & Ernst* cases and the fact that *Ernst & Ernst* left the question open. *See also SEC* v. *Trans Jersey Bancorp.,* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,818 (D.N.J. 1976).

itself in its *amicus* brief in *Ernst & Ernst:* since the language of the rule and statute construed in *Ernst & Ernst* are the same irrespective of the identity of the plaintiff, the *scienter* standard for proof of a violation must be the same irrespective of the identity of the plaintiff. An "attempted distinction based upon the identity of the plaintiff ignores the crucial difference between the question of violation and the question of entitlement to . . . relief."* *Accord, Ernst & Ernst, supra,* 425 U.S. at 217-18 (Blackmun, J., dissenting). Indeed, adoption of a lower standard of culpability in Commission injunction proceedings would destroy the utility of such proceedings in obtaining private redress. A finding of a violation in a Commission proceeding could not be used as collateral estoppel in a subsequent damage action because the *Ernst & Ernst* standard—which governs damage suits—would not have been employed.

As the trial court recognized, only policy considerations** could distinguish the requirements for proof of a Rule

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* Brief for the Securities and Exchange Commission as *Amicus Curiae* at 17, *Ernst & Ernst, supra,* 425 U.S. 185.

In *Ernst & Ernst*, the Commission argued that negligence should be sufficient to establish a violation of Rule 10b-5, but that proof of additional elements should be required to obtain civil damages. *Id.* at 23, 25. The Supreme Court rejected the argument; it held that *scienter* was required to prove a violation of Rule 10b-5, not that it was required to give rise to the remedy of civil damages. *See* Berner & Franklin, *supra,* 51 N.Y.U. L. Rev. at 780-81. The Commission's present argument that negligence is sufficient to prove a violation in an injunction action therefore is no more than an attempt to resurrect the argument already rejected by the Supreme Court.

** The Commission's policy argument appears to be grounded on the assumption that an injunction is merely mild, prophylactic relief. While courts have so described it, this approach ignores the extremely serious consequences which may accompany an injunction. The defendant, if an attorney, broker-dealer, accountant or a practitioner of certain other professions, may effectively be deprived of his livelihood

(footnote continued on following page)

10b-5 violation in an injunction action as opposed to a private damage action. (420 F. Supp. at 1241; JA 169) But in *Ernst & Ernst* the Supreme Court found no reason even to examine such considerations, since the language and history of Section 10(b) and Rule 10b-5 were dispositive of the appropriate standard of culpability. *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 214 n. 33; *see SEC* v. *American Realty Trust, supra,* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,913 at 91,440. The Court, moreover, had already rejected the Commission's argument, made again to the district court and to this Court, that the harmful impact on investors of even unintentional disclosure of material, inside information should override the congressionally determined requirement of intentionally deceptive or manipulative conduct. 425 U.S. at 198-99. Hence, Judge Ward properly concluded that the Commission's policy arguments could not justify a holding that *scienter* is not an element of a 10b-5 violation simply because the plaintiff happens to be the Commission.

The Commission's efforts to avoid the consequences of the Supreme Court's reasoning in *Ernst & Ernst* are unpersuasive.

The Commission argues first that *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963), stands for the

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as a result of an injunction. Elsen & Lupert, *Scienter for Injunctions,* 10 Rev. of Sec. Reg. 925 (1977); *see* Section 15(b)(4)(C) of 1934 Act, 15 U.S.C. § 78o(b)(4)(C); Sections 15B(c)(2), (4) of 1934 Act, 15 U.S.C. § 78o-4(c)(2), (4); Section 203 (e)(3) of Investment Advisors Act of 1940, 15 U.S.C. § 80b-3(e)(3); Rule 2(e)(3)(i) of the SEC Rules of Practice, 17 C.F.R. § 201.2(e)(3)(i) (1976). Certainly he will be subject to expense in defending the action, and to damage to his reputation and legitimate business activities if violations are established. *See SEC* v. *Harwyn, supra,* 326 F. Supp. at 952. He may be subject to prosecution for criminal contempt if there is a violation of the terms of the injunction in the future. These consequences can hardly be characterized as "mild." *See generally* Berner & Franklin, *supra,* 51 N.Y.U. L. Rev. at 785-87.

proposition that the Commission need prove only negligence to obtain an injunction. (SEC br. 33-35) But, in another of its "selective disclosures", the Commission fails to point out that *Capital Gains* was an action to enjoin violations of Section 206(2) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6(2), not Section 10(b) of the Exchange Act or Rule 10b-5. In *Capital Gains,* the Court held, on the basis of its analysis of the legislative history and purposes of the Advisors Act, that a violation of Section 206(2) did not require proof of *scienter.* 375 U.S. at 190-95. But *Ernst & Ernst* held, on the basis of the legislative history and purpose of the Exchange Act, that *scienter* is an element of a Section 10(b) or Rule 10b-5 violation. Hence, *Capital Gains* is of little relevance here. Indeed, the very sort of policy arguments relied upon by the Court in *Capital Gains* were explicitly rejected in *Ernst & Ernst.** *Compare Capital Gains, supra,* 375 U.S. at 186-97, 200-01, *with Ernst & Ernst,* 425 U.S. at 198-99. As one commentator recently wrote:

> "[*Ernst & Ernst* v.] *Hochfelder* would seem to preclude application of the approach taken in *Capital Gains* to the rule 10b-5 situation. . . . *Scienter* must

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* Although *Capital Gains* is not authoritative here because it dealt with a different statute, its approach seems inconsistent with that taken by the Supreme Court in *Ernst & Ernst* and *Santa Fe Industries, Inc.* v. *Green, supra,* and probably is no longer the law. *See* Berner & Franklin, *supra,* 51 N.Y.U. L. Rev. at 781-87. Among other things, the *Ernst & Ernst* Court flatly rejected the contention that *scienter* should not be required because the effect of the conduct at issue is independent of the mental state of the actor—a proposition which is much of the basis for *Capital Gains. Compare Ernst & Ernst, supra,* 425 U.S. at 198-99, *with Capital Gains, supra,* 375 U.S. at 186-97, 200-01. The Supreme Court's cryptic citation of *Capital Gains* in footnote 12 of the *Ernst & Ernst* opinion, 425 U.S. at 194 n. 12, appears merely to have illustrated the Court's statement that it would leave for another day the standard of culpability to be applied in Commission injunction actions under Rule 10b-5.

> be viewed as an essential element of rule 10b-5, and the court in *Bausch & Lomb* correctly held that this was so regardless of the identity of the parties or the nature of the relief sought." Case Comment, *supra, Scienter and SEC Injunction Suits: SEC* v. *Bausch & Lomb, Inc. and SEC* v. *World Radio Mission, Inc.,* 90 HARV. L. REV. at 1022-23.

The Commission next argues—as it did in its abortive motion for summary reversal—that this Court's recent decision in *SEC* v. *Universal Major Industries Corp., supra,* 546 F.2d 1044, reaffirms pre-*Ernst & Ernst* determinations that negligence is sufficient to prove a violation of Rule 10-5 in an SEC injunction action, relying heavily on the Court's statement in *Universal Major Industries* "that in SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and *scienter* is not required." *Id.* at 1047. *Universal Major Industries,* however, involved a radically different factual and legal setting and, therefore, has little bearing here. The Court there affirmed the issuance of a permanent injunction restraining the defendant from violating Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e, which prohibits the sale of unregistered securities. The Court rejected the defendant's argument that *scienter* was a necessary element to aiding and abetting liability under Section 5 (*id.* at 1046) and, in any event, did not base its decision on that ground:

> "because the District Court found that appellant in some circumstances knew and in other circumstances had reason to know that his client was engaging in illegal transactions with the aid of [defendant's] letters and that [defendant's] acts were performed with knowledge or reckless disregard of the truth." *Id.* at 1047.

Thus, the Court found *scienter* in *Universal Major Industries,* and the statement relied upon by the Commission

therefore was dictum. Moreover, as noted, *Universal Major Industries* involved Section 5 of the 1933 Act, not Section 10(b) of the Exchange Act and Rule 10b-5, which were the exclusive focus of the Supreme Court's statutory analysis in *Ernst & Ernst*. Unlike Section 10(b) and Rule 10b-5, Section 5 of the 1933 Act does not require *scienter*. Hence, this Court's dictum was correct, applied to the facts of *Universal Major Industries,* and by no means inconsistent with the trial court's decision here.

The holding in *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976), also is consistent with the decision below.* The Commission there established that the defendants were engaged in selling securities via deceptive representations, that they intended to continue to do so unless enjoined, and that they persisted in this intention notwithstanding the Commission's and the Court's determination that their conduct was deceptive. Thus, the Commission established in *World Radio Mission* that the defendants' *proposed* actions were likely to be accompanied by *scienter* in the *Ernst & Ernst sense.* As the First Circuit stated:

> "We may add that since an injunction is entered only after an adjudication that defendants' proposed

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* There is dictum in *World Radio Mission* to the effect that the defendant's state of mind is irrelevant in a Commission injunction action. 544 F.2d at 540-41. The dictum, however, is inconsistent with cases in this Circuit which establish the contrary. *E.g., Universal Major Industries Corp., supra,* 546 F.2d at 1048. Equally important, it ignores the dispositive reasoning of *Ernst & Ernst* as to the language and history of Section 10(b) and is, in our opinion, simply wrong. *Accord,* Berner & Franklin, *supra,* 51 N.Y.U. L. Rev. at 794-97. The First Circuit itself suggested that its holding was limited to Section 17(a) of the 1933 Act, which, unlike Section 10(b), contains language which the *Ernst & Ernst* Court recognized does not require *scienter.* 544 F.2d at 541 n. 10; *but see Sanders* v. *John Nuveen & Co.,* [Current] Fed. Sec. L. Rep. ¶ 96,030 at 91,615 (7th Cir. 1977); *SEC* v. *American Realty Trust, supra,* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,913 at 91,440; Berner & Franklin, *supra,* 51 N.Y.U. L. Rev. at 796 and n. 221.

> conduct prima facie violates the statute, their demonstrated intent to continue evidences, at the least, an intent to do what they now know a federal court, as well as the SEC, has found deceptive." 544 F.2d at 541 (footnote omitted).

Hence, the First Circuit sustained issuance of an injunction only on a finding that the defendants' proposed conduct was accompanied at least by reckless disregard of the probable fraudulent effect of their activities. *See generally* Case Comment, *supra, Scienter and SEC Injunction Suits: SEC* v. *Bausch & Lomb, Inc. and SEC* v. *World Radio Mission, Inc.,* 90 HARV. L. REV. at 1027.

2. *The Trial Court Correctly Concluded That There Was No Violation of Section 10(b) or Rule 10b-5*

The Commission's fall-back position is that, even if *scienter* is an element of a 10b-5 violation in an injunction action, it was established here. It argues first that the trial court applied an erroneous legal standard in determining that Mr. Schuman and Bausch & Lomb lacked *scienter.* (SEC br. 48-52) It then argues, in any event, that recklessness satisfies the *Ernst & Ernst* test and that the defendants' conduct was reckless here. (SEC br. 52-66)

The strained argument that "intentional and knowing conduct" constitutes *scienter* within the meaning of *Ernst & Ernst* (SEC br. 48)—the claim that Mr. Schuman possessed intent to defraud simply because he was "competent and in full command of his senses" (*id.* 49 n. 82)—reduces itself to the proposition that voluntary conduct constitutes *scienter,* even absent knowledge that one's conduct is wrongful or reckless disregard of its likely consequences. Thus, the Commission's proposed standard of culpability is even lower than the negligence test so emphatically rejected by the Supreme Court in *Ernst & Ernst.* The Court there

repeatedly spoke of *scienter* as an intent to deceive, defraud or manipulate and construed "manipulative", as used in Section 10(b), as connoting "intentional or willful conduct *designed to deceive or defraud* . . ." 425 U.S. at 199 (emphasis supplied). The Commission's proposed standard simply ignores the entire thrust of *Ernst & Ernst*.

The Commission's reliance on this Court's recent decision in *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171 (2d Cir. 1976), in support of its proposed standard—as well as the other cases it cites—is wholly misplaced. The cases stand only for the proposition that *scienter* in the *Ernst & Ernst* sense entails "proof of intention to deceive, manipulate or defraud—not an intention to do this in knowing violation of the law." *Arthur Lipper Corp., supra,* 547 F.2d at 181. In each case, the court found that the defendants engaged in conduct, *knowing that it was wrong,* and held only that a further showing that the defendants knew that their wrongful conduct violated Rule 10b-5 was unnecessary.*

* In *Arthur Lipper Corp., supra,* the Court found that the defendants charged full stock exchange commission rates and rebated half to a subsidiary of their mutual fund customers, "knowing that [the subsidiary] would retain the sums paid to it although these should have been turned over to the funds . . ." 547 F.2d at 181. In *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976), the issue was whether an accounting firm which participated in the preparation of misleading financial statements possessed the requisite *scienter*. The Court concluded that it did, noting that a partner in the firm referred to a crucial transaction as "fictitious" and "artificial" and that the firm conceded "that it was actually aware of the facts that the Trial Court correctly determined made [the firm's] affirmations misleading . . ." 540 F.2d at 30, 33. And in *United States* v. *Charnay*, 537 F.2d 341 (9th Cir.), *cert. denied*, 97 S. Ct. 528 (1976), the Court sustained an indictment which alleged, among other things, that the defendants "did devise *and intend to devise* a scheme and artifice to defraud . . ." *Id.* at 358 (emphasis supplied). The majority opinion held that it is "necessary for the prosecution to show an intentional act with a realization on the defendant's part that he was doing a wrongful act." *Id.* at 358, 352, *quoting with approval United States* v. *Peltz*, 433 F.2d 48, 55 (2d Cir. 1970).

See also United States v. *Dixon*, 536 F.2d 1388, 1395-97 (2d Cir. 1976).

Here, Judge Ward held that Mr. Schuman and Bausch & Lomb lacked *scienter* because they did not intend to confer any improper trading advantage and because they did not act recklessly under the circumstances. (420 F. Supp. 1241-44 and n. 4; JA 169-73, 185-89 n. 4) He did not require proof that the defendants acted with knowledge that their conduct violated Rule 10b-5. Hence *Lipper* and the other cases cited by the Commission are inapposite here.

The Commission's claim that Mr. Schuman and Bausch & Lomb acted recklessly, and therefore possessed the requisite *scienter,* is misdirected to this Court. Assuming *arguendo* that recklessness would satisfy the *Ernst & Ernst scienter* standard, which we dispute,* Judge Ward squarely found that Mr. "Schuman's behavior certainly does not establish recklessness verging on intent to deceive, manipulate or defraud." (420 F. Supp. at 1244 n. 4; JA 189 n. 4) And since Judge Ward applied precisely the same standard of recklessness now urged by the Commission—the test established in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1305 (2d Cir. 1973) (SEC br. 53 n. 91)—the only remaining question is whether Judge Ward's finding that Mr. Schuman did not act recklessly was "clearly erroneous".

The Commission's recklessness argument boils down to the claim that Mr. Schuman acted recklessly in inadvertently releasing the earnings estimate to MacCallum in the telephone call on the afternoon of March 16 and in the

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* The clear intention of the Supreme Court in *Ernst & Ernst,* we submit, was to require proof of "conduct designed to deceive or defraud investors . . ." in order to establish a 10b-5 violation. 425 U.S. at 199. Hence, a showing of recklessness is insufficient as a matter of law to make out a violation of Rule 10b-5.

few hours that followed.* Moreover, it is based in large part on inaccurate and misleading characterizations of the evidence.**

The trial court held that Mr. Schuman did not act recklessly on the afternoon of March 16. (420 F. Supp. at 1242-44 n. 4; JA 185-89 n. 4) It stated:

> "Inasmuch as the Supreme Court did not address itself to a definition of reckless behavior which would

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* The Commission briefly asserts also that Bausch & Lomb "recklessly" failed to have written policies or procedures concerning the release of corporate information and that Mr. Schuman acted recklessly in connection with the analyst interviews on March 15-16. (SEC br. 56-57) Both contentions are makeweights.

Surely the fact that Bausch & Lomb failed to write down its policies for dealing with inside information was not reckless per se. Indeed, the Commission repeatedly has promised to promulgate written policies to guide corporate executives in dealing with the problem of inside information, but has been unable to produce them. We suggest it would not concede that its own actions have been reckless. *Supra*, p. 8.

Nor did Mr. Schuman act recklessly in the analyst interviews on March 15-16. The trial court found that Mr. Schuman did not there divulge any material inside information and, at least as important, that he "appears to have attempted to candidly discuss that which was general knowledge . . . while parrying efforts to lure him into forbidden territory." (420 F. Supp. at 1236; JA 157)

** For example, the Commission states that Mr. Schuman "twice telephoned MacCallum to reveal prematurely Bausch & Lomb's first quarter earnings estimate to him." (SEC br. 58) The record establishes, however, and the trial court found, that Mr. Schuman did not call MacCallum in order to reveal an earnings estimate to him. Mr. Schuman called MacCallum's office, not expecting to find MacCallum already back from Rochester, because of the inaccurate rumor being disseminated in the marketplace that Mr. Schuman had given MacCallum an earnings estimate for the first quarter. (420 F. Supp. at 1238; JA 160-61, 92 ¶ 53) During the telephone call, Mr. Schuman's own estimate "popped out". (420 F. Supp. at 1243 n. 4; JA 188, 393) There never was any intention to disclose the earnings estimate to MacCallum. The second telephone call was placed to correct the estimate which Mr. Schuman had inadvertently disclosed to MacCallum. (420 F. Supp. at 1238; JA 161, 275, 93 ¶ 55)

suffice for culpability, however, the Second Circuit opinions which do deal with the issue, are helpful. Their language, coupled with the Supreme Court's emphasis that *scienter* means *intent* to deceive, manipulate, or defraud leads to a conclusion that only what Judge Friendly has characterized as 'the kind of recklessness that is equivalent to willful fraud', *TGS, supra,* at 868, will serve as a basis for liability.

"Though hardly to be recommended, Schuman's disclosure to MacCallum over the telephone on March 16 cannot be likened to constructive fraud. His conduct was not recklessness bordering on intent to deceive, manipulate, or defraud.

"It is clear that Schuman was charged with, 'the duty of the chief executive officer of a publicly held company to avoid private disclosure. . . .' *Geon, supra* at 47. This duty and the nature of conduct constituting an actionable breach thereof were thoughtfully discussed in *Lum's.*

"It is instructive to compare the instant case with the facts out of which *Lum's arose.* There, Chasen, the chief operating officer of the defendant corporation, was the recipient of information that earnings were likely to be considerably lower than had been anticipated. He passed this intelligence on to Simon, a registered representative and institutional salesman for a broker-dealer firm.

"Simon and Lum's had an understanding that Simon was to be informed of important corporate developments so that his clients would not think him unprepared; 'a practice presenting a potential for abuse.' 365 F. Supp. at 1058-59. One such client was IDS. Simon proceeded to convey the information to certain IDS employees who, acting upon it, sold all the Lum's stock in portfolios under their control.

"In discussing Chasen's culpability, the Court conceded:

> 'Granted that what constitutes negligent conduct in this type of situation is far from clear, it is evident that Chasen owed a primary or fiduciary duty to the investing public not to abuse his position as insider in possession of confidential corporate information by disclosing it to someone who might use it for personal purposes. Put somewhat differently, the issue could be expressed in terms of whether Chasen had a legitimate corporate purpose in disclosing the earnings projections to Simon. See 2 Bromberg, Securities Law, § 7.5 (3)(d) (1971).
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> * * * * *
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> [The understanding between Simon and Lum's] is just the sort of selective disclosure for personal purposes that ultimately works unfairness in the markets: some people are better informed and thus can conduct better analyses, in reaching decisions to act, because of unfair advantages not enjoyed by others—even if they do not take direct action on the specific information conveyed. Thus I conclude that Chasen breached his duty by transmitting the information to Simon, and should be liable for the foreseeable consequences of that act.' 365 F. Supp. at 1058.

"The Court identified a second prong of the negligence question: 'should Chasen have known that Simon would pass along the confidential information to his clients?' This question was answered affirmatively, the Court concluding that it was not 'reasonable under the circumstances,' for Chasen to believe that Simon would 'keep the faith.' A finding of negligence resulted.

"The instant facts are very different. Schuman's decision to go public with a figure after learning of the \$.60 rumor and his determination to call Mac-

Callum's office would not, in themselves, have created liability. At least arguably he was acting for a legitimate corporate purpose. The advice of then General Counsel Loomis is worthy of note:

> 'I do feel that a service might be done by corporate management in calling attention through the appropriate channels to the institution whose forecasts have been circulated around the market that, in the opinion of management, that is just plain wrong.'

"By all accounts, the disclosure itself seems to have simply 'popped out,' quite without premeditation. But, the revelation could clearly serve no corporate purpose. Should Shuman have realized that the information would be passed along? His estimates were higher than those of MacCallum. MacCallum's slightly lower figure had already been disseminated; the rumor mill had already attributed it to Schuman. This state of affairs rendered the impact of Schuman's disclosure far less devastating than it might have been. Although, to be sure, a 'tip' 'takes on an added charge just because it is inside information,' *Geon, supra* at 48, when rumors have already circulated to the effect that an earlier piece of information was a 'tip,' this charge is greatly lessened.

"Schuman believed that he was correcting a mistaken impression that was liable to affect the market in BOL stock. Judged on a 'reasonable man' standard, his conduct might justify a finding of negligence. This question need not be reached since Schuman's behavior certainly does not establish recklessness verging on intent to deceive, manipulate, or defraud." (420 F. Supp. at 1243-44 n. 4; JA 186-89 n. 4)

The quoted portion of Judge Ward's opinion is a full refutation of the Commission's position, save for its com-

plaints concerning the manner in which Mr. Schuman released the earnings estimate to the public after the inadvertent release to MacCallum. Those quibbles also are without merit.

First, the Commission claims that Mr. Schuman called Dan Dorfman of the Dow Jones and *Wall Street Journal* only "as if in an attempt to remedy the breach caused by his disclosure of BOL's earnings". (SEC br. 58) The record, however, establishes that Mr. Schuman, upon hearing that an earnings estimate falsely had been attributed to him, determined to go public with a correct earnings estimate. (420 F. Supp. at 1238; JA 160, 392, 92 ¶ 53) He directed his secretary to ask Bausch & Lomb's financial officers to come to his office for that purpose before calling FDS. (JA 92 ¶ 53) Moreover, it is rather difficult to see how the Commission can seriously assert that it was reckless to "remedy the breach" inadvertently committed in the MacCallum call.

The Commission attempts also to suggest that Mr. Schuman's reliance on Dorfman to publish the earnings estimate was unreasonable because Mr. Schuman was uncertain what Dorfman would do with the information he had given him. The record is clear, however, that Mr. Schuman knew that Dorfman would, as he did, publish the 65 cent to 75 cent first quarter earnings estimate. Mr. Schuman was not sure how Dorfman would explain the events of the previous day, *i.e.*, the inadvertent manner in which the estimate was released after a false rumor that Mr. Schuman had released an estimate was disseminated in the market. (JA 279-80)

The Commission's further claim that Mr. Schuman's action was unreasonable per se because he knew that the estimate would not appear in the paper until the next morning likewise fails. To begin, however, there was no reason for Mr. Schuman to have assumed that Dorfman—

who worked for Dow Jones—would not immediately have put the information on the Dow Jones broad tape rather than saving it for his column the next morning. (Ex 380-83) Furthermore, the inadvertent release of the earnings estimate took place some time after 2:24 p.m. on the afternoon of March 16. The Exchange was open only until 3:30 p.m., little more than one hour beyond the first MacCallum telephone call. Mr. Schuman plainly thought that the lengthy period typically required for Bausch & Lomb to issue a press release (420 F. Supp. at 1242; JA 172) would not have permitted issuance and dissemination of a release before the closing of trading on March 16 in any event. Hence, the call to Dorfman—which promised to and in fact did achieve wide public disclosure of the earnings estimate no later than the morning of March 17—was just as effective a means of dissemination as a formal press release.

In short, the Commission's effort to portray Mr. Schuman's behavior as reckless—notwithstanding the trial court's flatly contrary finding—falls of its own weight. It is contructed chiefly on a foundation of the sort of "selective disclosures" which the Commission wrongly attributes to Mr. Schuman.

III

The Commission's Other Claims Are Without Merit

Grasping at straws, the Commission puts forward several other claims of error, all of which are frivolous.

First, the Commission argues that the trial court's statement that "injunctions are extraordinary remedies" (420 F. Supp. at 1245; JA 175) evidences a fundamental misperception of the nature of the relief sought. The statement, however, is both correct and dictum. An injunction in an SEC enforcement proceeding is an "extraordinary"* and "drastic"** remedy. *See supra*, p. 62 n. 2. The trial court is required to assess all those considerations of fairness which are the traditional concerns of a court of equity.*** The cases relied upon by the Commission are inapposite. They simply stand for the well-established proposition that proof of irreparable injury is not necessary in an SEC enforcement proceeding, since that requirement is met by proof of a likelihood of a future violation, the statutory prerequisite to a grant of injunctive relief in such a proceeding. *E.g.*, *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F.2d at 808.

The Commission challenges also the trial court's observation that "[t]he permissible scope of corporate communications with securities analysts" is an appropriate

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* *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, *supra*, 480 F.2d at 405 (Mansfield, concurring and dissenting); *SEC* v. *Pearson*, 426 F.2d 1339, 1343 (10th Cir. 1970).

** *SEC* v. *Torr*, 87 F.2d 446, 450 (2d Cir. 1937); *SEC* v. *Koracorp Industries, Inc.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. ¶ 95,532 at 99,702 (N.D. Cal. 1976).

*** *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F.2d at 808; *SEC* v. *Manor Nursing Centers, Inc.*, *supra*, 458 F.2d at 1102; *SEC* v. *Keller Industries, Inc.*, *supra*, 342 F. Supp. at 660.

area for guidance from the Commission. (420 F. Supp. at 1245; JA 175) This statement too is both correct and dictum. The trial court simply recognized, as have courts and the Commission, the difficulties faced by corporate management attempting in good faith to conform their conduct to the requirements of the securities laws and to do so without the luxury of time for quiet reflection and hindsight, but under the immediate pressure of questioning by knowledgeable and persistent analysts, whom they are encouraged to meet with pursuant to the "open door" policy set by both the Commission and the New York Stock Exchange. (*See* 420 F. Supp. at 1245 n. 5; JA 189-90; *cf. Electronic Specialty Co.* v. *International Controls Corp.*, 409 F.2d 937, 951 (2d Cir. 1969))

Lastly, the Commission challenges the trial court's denial of its request that Mr. Schuman and Bausch & Lomb be ordered to adopt and maintain written procedures designed to assure their compliance with Section 10(b) and Rule 10b-5. The trial court's denial of this ancillary relief clearly was within the proper exercise of its discretion. The same factors which led the court correctly to conclude that injunctive relief was unnecessary also support its conclusion concerning the request for written guidelines. Moreover, the procedures adopted by Bausch & Lomb and Mr. Schuman promptly after the disputed events of March, 1972 (*see supra*, pp. 36-37), prevented any violations—and even arguably improper conduct—in the four years between March 1972 and the trial. Thus, it is clear that the trial court did not, and did not have to, rely on the memorandum of written policies presented to it after trial in denying the Commission's request for ancillary relief.*

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* In its brief, the Commission suggests that it was reversible error for the trial court to consider the fact that, subsequent to the trial,

(footnote continued on following page)

(420 F. Supp. at 1245-46; JA 176) Similarly, the court's reflection on the appropriateness of general administrative action (*ibid.*), rather than the particular relief requested in this case, was no more than a further observation on the appropriateness of guidelines on management-analyst communications.

Bausch & Lomb reduced to writing the procedures described by Mr. Schuman in his testimony. The court's decision makes clear that it did not rely on these written procedures in denying relief. (420 F. Supp. at 1245; JA 176) Nevertheless, the circumstances in which the procedures were adopted are set forth in the letter attached as Annex 2. In the event the Court regards it as appropriate, it may consider the latter as part of the record pursuant to Rule 10(e), Fed. R. Ap. P.

CONCLUSION

As the Supreme Court only recently reiterated, "[T]he historic injunctive process was designed to deter, not punish." *Rondeau* v. *Mosinee Paper Corp.*, 422 U.S. 49, 61 (1975). The record in this case demonstrated clearly that there is no reasonable likelihood of a future violation of the securities laws by these defendants; and the court's conclusion that an injunction was unnecessary and, therefore, inappropriate, was compelled by that record. The trial court committed no error; its sound judgment and decision should be affirmed.

Dated: New York, New York
July 1, 1977

Respectfully submitted,

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ANNEX 1

This annex sets forth the detailed and specific factual bases underlying the trial court's findings that the alleged disclosures in the analysts meetings of March 15-16, 1972 were not disclosures of material, nonpublic information.

1. The Trial Court Correctly Found That Mr. Schuman Did Not Disclose Earnings Estimates in the Interviews

The Commission argues that the trial court incorrectly concluded that Mr. Schuman's disclosure to the analysts of "BOL's reduced internal annual per share earnings estimates" was not material. (SEC br. 19) But the trial court specifically found that "it cannot fairly be said that Schuman made statements which could be characterized as disclosures of earnings" and that the information which he did disclose was not material. (420 F. Supp. at 1235, 1237; JA 153, 159-160)

The court's finding was fully supported by the record. Mr. Schuman did not state "that yearly earnings would be between $3.00 and $5.00 a share" as the Commission states, without citation, in its brief. (SEC br. 72) During the course of their meeting, Wien and Clancy indicated that they had seen Sanders, another analyst who met with Mr. Schuman on March 15, as they entered Mr. Schuman's office. They asked Mr. Schuman what Sanders was forecasting for the year. Mr. Schuman responded that Sanders was forecasting $5.00 for the year. Mr. Schuman did not comment on that particular estimate, but went on to tell Wien and Clancy that analysts generally had forecast figures over a very wide range, that Bausch & Lomb itself had no idea how well Soflens contact lenses would do, and that he generally encouraged analysts to be more conservative. (JA 357-59; 244-48) The reference to the $3.00 per

share estimate is taken out of context. At another point in the conversation, Wien or Clancy suggested—apparently sarcastically in urging Mr. Schuman to adopt their proposed public relations program—that Bausch & Lomb might earn as little as $3.00 per share in 1972. (JA 363-64) Mr. Schuman responded to the sarcastic question with a sarcastic remark. (JA 364; Ex 88-89)

During his meeting the next day with MacCallum, Mr. Schuman stated that Bausch & Lomb was preparing its quarterly forecast—a routine budgeting practice. (JA 254-56, 378-79) He did not say that management was revising its estimates downward, and the budget itself was not public. If the inference that the revision was downward was "inescapable", as the Commission claims (SEC br. 72), it was precisely because it was general knowledge in the investment community that various factors known to the public, including the spate of negative publicity surrounding Soflens during the first quarter of 1972, would have a negative impact on Bausch & Lomb sales and earnings.

Mr. Schuman's statements did not disclose any earnings figures and were well within the bounds of proper disclosure. (420 F. Supp. at 1231-33 n. 1; JA 177-83)

2. The Discussion of Aphakic Lenses and Minikits Was Insignificant

The Commission further claims that the trial court erred in concluding that the time of the introduction of the Soflens minikit and aphakic lens was not material. (SEC br. 19) However, Bausch & Lomb's expectations as to when the first shipments of the aphakics and the minikit would take place were routine operational details, which the company disclosed to anyone who requested such information, and which were subject, as with any new addition to a product line, to changes and slight delays. (*See* JA 364-65)

Neither the products themselves, nor their proposed introduction date, were touted by the company in any public releases or statements. The aphakic lens and the minikit were listed on Bausch & Lomb's basic "Soflens sales policy and price list" (Ex 384-87), dated March 1, 1972, which was distributed to the Soflens sales force on or before March 1, 1972 (JA 89 ¶ 39) and through them to practitioners. As the court found, Bausch & Lomb's marketing division had been answering customer inquiries on the availability of the products with similar information to that disclosed by Mr. Schuman to each of the analysts. *See supra*, p. 21.

Moreover, the question of whether the aphakics and the minikits would be introduced in the first quarter rather than the second was not objectively significant.* The court found, and the Commission does not contest, the following:

> "The potential financial impact of the later introduction of the two products seems insubstantial. An internal forecast of sales of the aphakics for the first quarter of 1972, made in February, estimated receipts of $480,000. At the same time, the estimate for the minikits was $540,000, the two aggregating $1,020,000. Total sales for the first quarter were $42,960,000." (420 F. Supp. at 1235; JA 153; Ex 22, 25)

As this Court made clear in *SEC* v. *Texas Gulf Sulphur Co., supra*, 401 F.2d at 849, "not only the probability of an event but also the magnitude of its potential impact on a company's fortunes are relevant to the determination of materiality." *SEC* v. *Geon Industries, Inc., supra*, 531 F.2d

* Since the interviews took place two weeks from the end of Bausch & Lomb's first quarter, and the shipment of aphakics and minikits had not begun, it was clear that significant shipments in the first quarter were unlikely.

at 47, quoted in the trial court's opinion. (420 F. Supp. at 1235; JA 153.)

The lack of significance of the discussion about aphakics is highlighted by the fact that Clancy did not even recall the discussion (420 F. Supp. at 1235; JA 154; Ex 74) and MacCallum regarded it as "irrelevant". (JA 502; 420 F. Supp. at 1236; JA 157) Nor did Mr. Schuman attach any significance to the fact that the products would be introduced in the first quarter rather than the second. (JA 364-65)

3. Mr. Schuman's Recognition That the Flak Appeared to Be Hurting Soflens Sales Was Not Material

Finally, the Commission argues that the trial court committed legal error by concluding that Mr. Schuman's statements concerning the flattening of Soflens sales did not convey material adverse inside information.* The trial court found that "the context in which Schuman discussed declining [Soflens sales] does not permit characterization

* Although it was in no event material information, there was no credible evidence that Mr. Schuman made the alleged statement that the Soflens sales rate was less than one lens per practitioner per week. (SEC br. 10) Mr. Schuman testified that he did not make the statement. (JA 254) The Commission called neither Wien nor Clancy to testify. Instead, it relied solely on a transcript of the Commission's examination of Clancy at an investigative hearing, at which neither Bausch & Lomb nor Mr. Schuman was represented or had any opportunity for examination. The transcript contains Clancy's hearsay account of a purported statement by Wien that Mr. Schuman indicated that the rate of sales was less than one lens per practitioner per week. (Ex 81-82) The conflict with Mr. Schuman's testimony did not need to be resolved, since the alleged statement did not have any significance in the absence of data as to the number of fitters, which Bausch & Lomb kept highly confidential. (JA 372-74) But in any event, Clancy's statement, in light of the circumstances in which it was made, did not merit any weight. And clearly the trial court was not required to give it any weight.

of the statements as disclosure of inside information." (420 F. Supp. at 1235; JA 154) The court's finding was correct and fully supported by the record.

As the court concluded, it was common knowledge among members of the investment community that the momentum of Soflens contact lens sales had slowed. (420 F. Supp. at 1229, 1236; JA 145, 157) The facts leading to this conclusion, discussed by the trial court, were public, not internal corporate information. The negative articles in the press concerning the safety and quality of soft contact lenses (*supra*, pp. 12-13) were widely publicized. The filling of the pipeline to practitioners with the introductory sale of large kits of Soflens contact lenses in the second half of 1971, making sales in the first quarter of 1972 dependent upon replacement sales or new orders "from presumably less interested practitioners who had not responded to the promotional campaign" and when "[c]onsumer acceptance was still a matter of speculation" also was widely known. (420 F. Supp. at 1229; JA 145; *see supra*, pp. 12-13) Thus, each of the analysts with whom Mr. Schuman met on March 15 and 16, like other members of the investment community, had concluded that Soflens sales had flattened before meeting with Mr. Schuman. (420 F. Supp. at 1235-37; JA 154-58) The impact of the negative publicity was the stated premise upon which the interviews were conducted. In this context it would have been incredible (and misleading) for Mr. Schuman to deny that the flak had any impact.

Mr. Schuman did not convey any significant new fact; rather, the analysts "test[ed] the meaning of public information", which the Commission itself has recognized as useful and appropriate. *Matter of Investors Management*, *supra*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. ¶ 78,163, at 80,521. Moreover, discussions with analysts

about trends in a company's business prospects were recognized at the time of these meetings as appropriate and useful. In this regard, as the trial court noted, then General Counsel Loomis in 1968 made the following widely publicized responses to questions with respect to management discussion of the implication on earnings of various levels in business. (420 F. Supp. at 1231-33 n. 1; JA 179-80):

Mr. Loomis was asked:

> "Now, with regard to future earnings, quite often company officials will, at the time of the annual meeting, express the belief or perhaps hope that the earnings for the then current year will be somewhat more than the earnings that have been reported for the year just finished. Later on in the year would it be proper for an investor, shareholder or analyst to discuss with the management operating conditions in the light of those expected at the time that that statement was made at the annual meeting?"

Mr. Loomis answered:

> "Yes, and I think it could well be useful." (Ex 240)

Mr. Loomis further was asked:

> "How about discussing the implications on earnings of a disappointing level of business?"

He responded:

> "Surely if they want to." (Ex 241)

Similarly, Commissioner Smith in a 1969 speech stated:

> "When the information involved is only further elaboration on developments that have already been publicized in a general (but meaningful) way, I be-

lieve that the information is sufficiently available if the corporation would make it available to any reasonable person who inquired. Or to put it more generally, 'availability' is a flexible concept that should be matched in each case to the nature of the information that is actually involved." (Ex 274)

The trial court's finding that Mr. Schuman's statements concerning Soflens sales were not material in the context of the "total mix" of information available at the time, but simply "link[s] in a chain of analytical information", like the court's findings with respect to the other statements discussed by the Commission, was eminently correct. The discussion of such information was perfectly consistent with the "open door" policy of the Commission, as well as the New York Stock Exchange, and the other pronouncements by the Commission on the appropriate relationship between public companies and security analysts.

4. The Analysts' Reactions Demonstrate That No Material Nonpublic Information Was Disclosed to Them

The conclusions that the analysts reached after meetings with Mr. Schuman on March 15 and 16, 1972 demonstrate that these interviews constituted merely one part of the analytical process for the analysts as distinguished from the "leaking" of highly significant negative information. As the trial court found, Mr. Schuman discussed essentially the same information with Sanders, Wien and Clancy and MacCallum. (420 F. Supp. at 1234, 1236; JA 152, 157) Yet, as the trial court also found:

> "[T]he analysts' reactions were by no means uniform. Sanders chose to recommend the purchase of BOL stock. Wien and Clancy, whose concern seems to have focused on the firm's marketing techniques, split, with Wien advocating sale while Clancy urged

> retention of two-thirds of the Brokaw holdings. MacCallum's decision to withdraw his 'buy' recommendation, according to his testimony, was formulated prior to his trip to Rochester. No fact relayed to him by Schuman changed his opinion on the stock." (420 F. Supp. at 1237; JA 159)*

Without challenging these factual findings the Commission suggests that because the various recommendations were made after meeting with Mr. Schuman, they must have been based upon "inside" information. Even though one of the analysts recommended "purchase," another "hold," and another "sell," the Commission complains that they all [illegible]ted after meeting with Mr. Schuman and admonishes [illegible] "the courts . . . should preserve informational access[illegible]ality in the market." (SEC br. 82) Note the absence of [illegible]ny reference to the concept of materiality.

The Commission's analysis here would prohibit corporations from discussing any matter with securities analysts, whether or not the information is believed to be material, or run the risk that any subsequent action by the analyst would establish that the conversation disclosed material nonpublic information. Such an approach directly repudiates the Commission's own recognition of the useful purposes served by meeting with analysts and its admonition that companies should "observe an 'open door' policy in responding to unsolicited inquiries concerning factual matters from securities analysts."

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* Similarly, the decline in Bausch & Lomb between the close of the NYSE on March 16 and March 20 cannot support an inference that Mr. Schuman made material disclosures. *Supra,* p. 35.

ANNEX 2

[Letterhead of Nixon, Hargrave, Devans & Doyle]

June 7, 1976

Re: Securities and Exchange Commission v.
Bausch & Lomb Incorporated, et al.
73 Civ. 2458 (RJW)

Hon. Robert J. Ward
United States District Judge
United States Courthouse
Southern District of New York
Foley Square
New York, N.Y. 10007

Dear Judge Ward:

In this morning's mail we received Plaintiff's Proposed Findings of Fact and Conclusions of Law and its Post-Trial Brief. We feel that one respect of those papers requires immediate response to set the record straight. The Commission, at several points in its papers, emphasized that Bausch & Lomb's procedures for handling relationships with securities analysts had not been reduced to writing. (See, e.g. Plaintiff's Proposed Findings 96, 97, 98, 99, 100 and 101; Plaintiff's Proposed Conclusions 13, 14 and 16; and Plaintiff's Brief at 26, 27, 32 and 33). Plaintiff repeatedly suggests that Bausch & Lomb's purported unwillingness to reduce its procedures to writing somehow justifies a conclusion that it is about to violate the securities laws, despite the fact that its existing procedures have prevented any violations during the more than four years since March 16, 1972.

The Court should not conclude from the Commission's emphasis on this point that Bausch & Lomb is or has been unwilling to reduce such procedures to writing, and the Commission's implication from this argument is totally unwarranted. In discussions with the Commission, both before and after the trial, Bausch & Lomb repeatedly and consistently offered to adopt written procedures and sought the assistance of the Commission in preparing them. The Commission never offered any assistance to Bausch & Lomb in developing such procedures, just as it has offered no such assistance to the Court.

However, after discussions with the Commission about this matter finally broke off following the trial, Bausch & Lomb voluntarily reduced to writing the policies and procedures that Mr. Schuman described to the Court at trial (Tr. 303-304, 307-311, 315, 337-342). Copies of the written procedures are enclosed. As was clear from Mr. Schuman's testimony, these procedures, whether oral or written, go well beyond the requirements of the securities laws and prohibit discussions of any matter not previously made public without regard to the difficult question of materiality.

In light of the Commission's failure to provide specific guidance in this area, the procedures are designed to insure that Bausch & Lomb continues, as it has for the last four years, to avoid even questionable conduct.

Respectfully yours,

/s/ William H. Morris
William H. Morris

cc: Benjamin Greenspoon, Esq., w/encl.

AFFIDAVIT OF SERVICE

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

JUDY KAUFFMAN, being duly sworn, deposes and says:

I am not a party to the action, am over 18 years of age and reside at 5 Tudor City Place, New York, New York 10017.

On July 1, 1977 I served the attached Appellees' Brief upon Harvey L. Pitt, Esq., General Counsel, Securities and Exchange Commission, 500 North Capitol Street, N.W., Washington, D.C. 20549.

Said service was made by depositing three copies of the attached Appellees' Brief enclosed in a postpaid properly addressed wrapper in an official depository under the exclusive care and custody of the United States postal service within the State of New York.

Judy Kauffman

Judy Kauffman

Sworn to before me this

1st day of July, 1977

Lewis A. Kaplan

Notary Public

LEWIS A. KAPLAN
Notary Public, State of New York
No. 60-7158700
Qualified in Westchester County
Commission Expires March 30, 1978